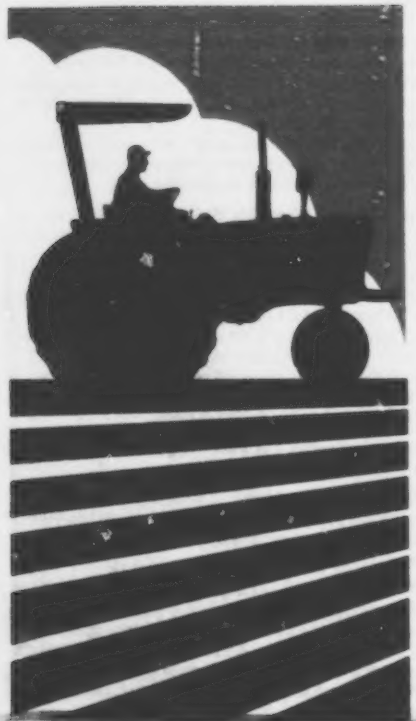
F 22/990

Department of the Treasury
Internal Revenue Service
Catalog Number 11049L

Publication 225

Farmer's Tax Guide

For use in preparing
1990 Returns



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Acknowledgement

The valuable advice and assistance given us each year by the National Farm Income Tax Extension Committee is gratefully acknowledged.

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Introduction

This publication explains how the federal tax laws apply to farming. Use this publication as a guide to figure your taxes and complete your farm tax return. If you need more information on any subject, get the specific IRS tax publication covering that subject. Many of these free publications are referred to throughout this publication. You can order them, along with any forms you may need, from the Forms Distribution Center for your area. Forms Distribution Center addresses and publication titles are listed at the back of this publication.

In compiling this *Farmer's Tax Guide*, we have adopted a number of suggestions that readers sent to us. We welcome your suggestions for future editions. Please send your comments and recommendations to us at this address:

Internal Revenue Service
Technical Publications Branch, T:FP:P
1111 Constitution Avenue, N.W.
Washington, DC 20224.

We respond to many letters by telephone. Therefore, it would be helpful to include your area code and daytime phone number along with your return address.

Farm tax classes. Many state Cooperative Extension Services conduct farm tax workshops in conjunction with the IRS. Please contact your county extension office for more information.

Important Changes for 1990

The following list highlights a number of changes in the tax law and administrative changes for 1990. A second list of items under *Important Reminders* contains information that may be helpful to know in preparing your tax return for 1990.

Disaster Assistance Act of 1989. If you received payments in 1989 under title 1 of the Disaster Assistance Act of 1989, and your tax year ended before April 1, 1990, you may file an amended return to defer these payments until 1990, provided you otherwise qualify for this deferment. If, on your return, you deferred crop insurance payments but not federal disaster assistance payments, you can file an amended return to also defer the disaster assistance payments. However, you are not required to do so. For tax years ending before April 1, 1990, you are permitted to defer crop insurance payments and not defer disaster assistance payments. You cannot, however, defer disaster assistance payments without deferring crop insurance payments. See Chapter 4.

Change of address. If you change your mailing address, you should use Form 8822, *Change of Address*, to notify IRS of your new address. Be sure to include your suite, room, or other unit number. If you are changing both your home and business addresses, complete two separate forms. However, individuals who are also household employers and file Form 942 can use one form. Send the form to the Internal Revenue Service Center for your old address.

New maximum net earnings for self-employment tax. The maximum net earnings subject to the self-employment tax increase to $51,300 in 1990. See Chapter 15.

New self-employment tax rate. The tax rate for self-employment tax is 15.3% for 1990. (For 1991, the tax rate remains at 15.3%.) The 2% credit for 1989 and prior years has been replaced by two deductions. See Chapter 15.

New wage maximum for social security taxes. The maximum wages subject to social security taxes increase to $51,300 in 1990. See Chapter 16.

New social security tax rate. The tax rate for social security taxes is 7.65% in 1990 for both the employee and the employer. (For 1991, the tax rate remains at 7.65%.) See Chapter 16.

Farmers and crew leaders must withhold income tax. For wages paid after 1989, farmers and crew leaders must withhold federal income tax from farm workers who are subject to social security taxes. See Chapter 16.

New $100,000 deposit rule. After 1990, undeposited social security and withheld income taxes that reach $100,000 or more in any eighth-monthly deposit period must be deposited by the second banking day. However, you are still required to make deposits within 3 banking days when undeposited taxes reach at least $3,000 at the end of an eighth-monthly deposit period. See Chapter 16.

Federal unemployment (FUTA) tax rate. The gross FUTA tax rate remains at 6.2% for 1990. (For 1991, the tax rate decreases to 6.0%) See Chapter 16.

Standard mileage rate for business use of a vehicle. The standard mileage rate for 1990 is 26 cents a mile for all business miles. You are not subject to the 15,000 mile annual limit that applied in earlier years. See Chapter 5.

General business credit. The following credits, which are part of the general business credit, are scheduled to expire as follows:

- The jobs credit and energy investment credit on September 30, 1990, and
- The low-income housing credit and research credit on December 31, 1990. See Chapter 9.

Family health insurance. If you are self-employed or if you own more than 2% of the outstanding stock of an S corporation, you can deduct up to 25% of the cost paid on your behalf for providing medical insurance for yourself and your family, if you meet certain requirements.

Under prior law, this deduction was scheduled to expire for tax years beginning after December 31, 1989.

The expiration date for this deduction has been extended to tax years beginning before October 1, 1990. If your tax year begins in 1990, you can include only medical insurance payments made before October 1, 1990, that provide coverage for periods before that date. See Chapter 5.

Intangible drilling and development costs. For tax years beginning after 1989, you can choose to write off intangible drilling and development costs over a 60–month period. See Chapter 14.

New Form 8824. Beginning in 1990, if you have a like-kind exchange, you must file Form 8824, *Like-Kind Exchanges*, in addition to Schedule D (Form 1040) or Form 4797. See Chapter 10.

Like-kind exchanges. Restrictions have been added to the rules allowing a tax-free exchange of like-kind property. If related parties exchange like-kind property, they must wait 2 years before either can sell or dispose of the property exchanged. See Chapter 10.

Penalties. Beginning in 1990, the following penalties for late tax deposits and late information returns are based on the length of time a deposit or information return is late. The penalty for furnishing statements to payees, however, is not time-related.

- ***Late tax deposits.*** After 1989, the penalty for a late tax deposit is:
  a) 2% for the first 5 days late,
  b) 5% for the 6th through the 15th day late,
  c) 10% for more than 15 days late, and
  d) 15% if the deposit is not made within 10 days after the IRS issues the first notice demanding payment.
- ***Late information returns.*** After 1989, the penalty for filing a late information return applies if you do not file by the due date, if you do not include all required information, or if you report incorrect information. The penalty is:
  a) $15 for each return filed within 30 days after the due date, up to a maximum of $75,000,
  b) $30 for each return filed after the 30-day period but by August 1, up to a maximum of $150,000, and
  c) $50 for each return filed after August 1, or never filed, up to a maximum of $250,000.

  Small businesses pay the same penalty for a return, but the maximums are lowered to $25,000, $50,000, and $100,000. A small business is one with average annual gross receipts of $5 million or less for the last 3 years ending before the calendar year the return is due, or since the business began if shorter.
- ***Late payee statements.*** After 1989, a $50 penalty applies for each statement you do not furnish a payee by the required date up to a maximum of $100,000. The penalty also applies if you do not include all required information, or if you report incorrect information.

Important Reminders

The explanations and examples in this publication reflect the interpretation by the Internal Revenue Service of tax laws enacted by Congress, Treasury regulations, and court decisions. However, the information given does not cover every situation and is not intended to replace the law or change its meaning. This publication covers some subjects on which a court may have made a decision more favorable to taxpayers than the interpretation of the Service. Until these differing interpretations are resolved by higher court decisions or in some other way, this publication will continue to present the interpretation of the Service.

Earned income credit. You, as an employer, must notify employees who worked for you and from whom you did not withhold income tax about the earned income credit. See Chapter 16.

Form W–4 for 1991. Farmers who have employees should make new Forms W–4 available to their employees who have income tax withheld, and encourage them to check their income tax withholding situation for 1991. Those employees who owed a large amount of tax or received a large refund for 1990 may want to file a new Form W–4. For more information, see Publication 937, *Business Reporting*.

Information returns (Form 1099 Series). If you make total payments of $600 or more during the year to another person, other than an employee or a corporation, in the course of your farm business, you must file information returns to report these payments for the year. See Chapter 2.

Social security tests for hand-harvest laborers. If you pay hand-harvest laborers less than $150 in annual cash wages, the wages are not subject to social security taxes, even if you pay $2,500 or more to all your farm workers. The hand-harvest laborer must meet certain tests. See Chapter 16.

Cancellation of debt. Generally, if you are solvent, you may not exclude a canceled business debt from your income. However, if you are a solvent farmer you may be able to exclude canceled farm debt from income. The rules for excluding income realized from cancellation of debt have been modified. See Chapters 4 and 10.

Depreciation. You must use the modified accelerated cost recovery system (MACRS) for tangible property you place in service in 1990.

Property placed in service in 1990 in a farming business is depreciated using a 150% declining balance method under MACRS. See Chapter 8.

Uniform capitalization rules. If you previously elected out of the uniform capitalization rules for costs in raising animals, and you did not revoke that election on your 1989 return, the special rules for depreciating farm property remain in effect for assets you placed in service after January 1, 1987. This election could only be revoked on the first return filed after 1988. After that, you must have consent from the IRS to revoke the election. See Chapter 7.

Penalties. Besides the following penalties that apply to 1990 returns, ***criminal penalties*** may be imposed for willful failure to file, collect, or pay, for tax evasion, and for making a false statement.

- The fraud penalty for underpayment of income, gift, or windfall profit taxes is 75% of the part of the underpayment due to fraud.
- A 20% penalty applies to the underpayment of income tax due to negligence or disregard of IRS rules and regulations. This penalty also applies to any substantial understatement of income tax, valuation overstatement, pension liabilities overstatement, and estate or gift tax valuation understatement.
- The penalty for not registering tax shelters with the IRS is the greater of 1% of the amount invested in the tax shelter, or $500.
- The penalty for not including tax shelter identification numbers on returns is $250 for each number omitted.
- The penalty on tax shelters for not keeping lists of investors in potentially abusive tax shelters is $50 for each person required to be on the list. The maximum penalty is $100,000 for each tax shelter in each tax year.
- The penalty for failure to pay tax is ½ of 1% of the unpaid tax for each month, or part of a month, the tax is unpaid. However, the penalty increases to 1% for each month beginning after the day levy may be made.

Taxpayer assistance. Publication 910, *Guide to Free Tax Services*, provides information on where to get help in preparing tax returns. It describes the year-round services available to resolve questions on bills, letters, and notices received from Internal Revenue Service Centers, as well as questions on the status of tax refunds. This publication lists free taxpayer information publications, with brief descriptions of their content, along with a list of related tax forms and schedules that you may need to complete your returns. For information on how to get Publication 910, see *IRS Publications* at the end of this publication.

Tele-Tax. The IRS has a telephone service called Tele-Tax. This service provides recorded tax information tapes on about 140 topics covering such areas as filing requirements, employment taxes, taxpayer identification numbers, and tax credits. Recorded information is available 24 hours a day, 7 days a week, to taxpayers using push-button telephones, and during regular working hours for those using dial telephones. The topics covered and telephone numbers for your area are listed in the Form 1040 instructions.

Unresolved tax problems. The IRS has a Problem Resolution Program for taxpayers who have been unable to resolve their problems with the IRS. If you have a tax problem you have been unable to resolve through normal channels, write to your local IRS District Director or call your local IRS office and ask for Problem Resolution assistance.

The Problem Resolution Office will take responsibility for your problem and make sure that it receives proper attention. Although this office cannot change the tax law or technical decisions, it can frequently clear up misunderstandings from previous contacts.

Hearing-impaired taxpayers who have access to TDD equipment may call 1–800–829–4059 to ask for help from Problem Resolution.

Rounding off to whole dollars. You may round off cents to the nearest whole dollar on your return and schedules. To do so, drop amounts under 50 cents and increase amounts from 50 cents to 99 cents to the next dollar. For example, $1.39 becomes $1 and $2.50 becomes $3.

If you do round off, do so for all amounts. However, if you have to add two or more amounts to figure the total to enter on a line, include cents when adding the amounts and only round off the total.

Reminders—Before you file your tax return, be sure to:

Use the address label. Transfer the address label from the tax return package you received in the mail to your tax return, and make any necessary corrections.

Attach all forms. Attach all forms and schedules in sequence number order. The sequence number is just below the year in the upper right corner of the schedule or form. Attach any other statements or attachments last, even if they relate to another form or schedule. Do not attach these other statements to the related form or schedule.

Fill out Schedule SE (Form 1040) if you had self-employment income of $400 or more.

List income, deductions, credits, and tax items on the correct lines.

Make sure you sign and date the tax return.

Pay by check. Attach a check for any tax you owe. If the check accompanies your Form 1040, write your social security number on the check. If the check accompanies Form 1120, Form

1120-A, or Form 1120S, write your employer identification number, the tax period, and the tax form number on the check. Also include the telephone number and area code where you can be reached during the day.

Use addressed envelope. Use the addressed envelope in your 1990 tax form instructions. If you do not have an addressed envelope, mail your return to the address listed for your area under *Where to File* in your 1990 tax form instructions.

Important Dates

You should take the action indicated on or before the dates listed. Saturdays, Sundays, and legal holidays have been taken into account, but local banking holidays have not. A statewide legal holiday delays a due date only if the IRS office where you are required to file is located in that state.

Due dates for monthly and eighth-monthly deposits of withheld income taxes and social security taxes are not listed here but are outlined in Publication 509, *Tax Calendars for 1991*.

Fiscal year taxpayers. Generally, the due dates listed in the calendar apply to all taxpayers whether they use a calendar year or a fiscal year. However, fiscal year taxpayers should refer to Publication 509 for certain exceptions that apply to them.

1991—Calendar Year

During January

Employers. Give copies of Form W-2 for 1990 to each agricultural employee whose wages are to be reported on Form 943 as soon as possible. The due date for giving Form W-2 to your employees is January 31, 1991. Copy A of Form W-2 must be filed by February 28, 1991.

January 15

Farmers. You may elect to pay your 1990 estimated income tax with Form 1040-ES. You can then file your 1990 federal income tax return, Form 1040, by April 15. If you do not pay with Form 1040-ES at this time, file your 1990 return by March 1.

January 31

Farm employers. File Form 943 to report social security taxes and withheld income tax for 1990. However, if you have already deposited the tax you owe for the year in full and on time, you have until February 11 to file the return. (Do not report wages for nonagricultural services on Form 943.)

All farm businesses. Give an annual information statement to recipients of certain payments you made during 1990. (You may need Forms 1099-INT or 1099-MISC.) See Chapter 2.

Federal unemployment (FUTA) tax. File Form 940 for 1990. If your undeposited tax is $100 or less, you can either pay it with your return or deposit it. If it is more than $100, you must deposit it. See Chapter 16. However, if you have already deposited the tax you owe for the year in full and on time, you have until February 11 to file the return.

February 11

Farm employers. File Form 943 to report social security taxes and withheld income tax for 1990. This due date applies only if you had deposited the tax for the year in full and on time. If not, you should have filed the return by January 31.

Federal unemployment (FUTA) tax. File Form 940 for 1990. This due date applies only if you had deposited the tax for the year in full and on time. If not, you should have filed the return by January 31.

February 28

All farm businesses. Report certain payments of $600 or more made during 1990 to a taxpayer other than a corporation. See Chapter 2. Use Form 1096 to summarize and transmit Forms 1099-INT and 1099-MISC.

All employers. File Form W-3, *Transmittal of Income and Tax Statements*, along with Copy A of all the Forms W-2 you issued for 1990. See Chapter 2.

March 1

Farmers. File your 1990 income tax return (Form 1040) and pay any tax due. However, you have until April 15 if you paid your 1990 estimated tax by January 15, 1991.

March 15

Corporations. File a 1990 calendar year income tax return, Form 1120. See Publication 542, *Tax Information on Corporations*.

April 15

Individual farmers. File an income tax return (Form 1040) for 1990 and pay any tax due if you did not file by March 1. See Chapter 2.

Partnerships. File a 1990 calendar year return. Use Form 1065. See Publication 541, *Tax Information on Partnerships*.

April 30

Federal unemployment (FUTA) tax. If you are liable for FUTA tax (see Chapter 16), you must deposit your actual federal unemployment tax liability with a depositary. No deposit is necessary if the liability for the quarter does not exceed $100.

July 31

Federal unemployment (FUTA) tax. If you are liable for FUTA tax, you must deposit your actual federal unemployment tax liability with a depositary. No deposit is necessary if the liability for the quarter, plus undeposited federal unemployment tax for the 1st quarter, does not exceed $100.

October 31

Federal unemployment (FUTA) tax. If you are liable for FUTA tax, you must deposit your actual federal unemployment tax liability with a depositary. No deposit is necessary if the liability for the quarter, plus undeposited federal unemployment tax for previous quarters, does not exceed $100.

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1. Importance of Good Records

A farmer, like other taxpayers, must keep records to prepare an accurate income tax return and be sure only the tax owed is paid. Items such as invoices, canceled checks, and cash receipts for paid bills that support entries in your books should be filed in an orderly manner and stored in a safe place.

Advantages of good records. Good records can save you time and money. You need records for efficient farm management, preparation of credit applications, and to support all items of income and expense reported on your tax return. Here are some ways in which they may help.

Identify source of receipts. Your records should identify the source, date, and amount of your receipt and show whether the item of income is taxable or nontaxable.

Record deductible expenses. Expenses may be forgotten when you prepare your tax return unless you record them when they occur. After recording the item in your books, maintain the document or receipt in a safe, well-organized file.

Figure depreciation deduction. You should note in a permanent record the assets used in your farming business that you can depreciate. Depreciation is the name given to recovering on your tax return the cost of your business property through periodic tax deductions. Without a record of the cost and other information on your business assets, you cannot figure your depreciation deductions. If you sell your assets, make capital improvements to them, or they become fully depreciated, only a permanent record along with invoices or receipts will show how much of their cost you have not recovered. See Chapter 18 for a sample depreciation record and a completed Form 4562, *Depreciation and Amortization*.

Figure your earnings for self-employment social security tax. The self-employment tax is part of the system for providing social security coverage for people who work for themselves. The social security benefits that you can get when you retire or become disabled, or the benefit payments to your family in case of your death, depend on how much you contributed to your social security account based on your net earnings. Your records should show how much of your earnings are subject to self-employment tax.

Support items reported on your income tax return. If your income tax return is examined by the Internal Revenue Service, you may be asked to explain and support the items reported. Adequate and complete records are always supported by sales slips, invoices, receipts, bank deposit slips, canceled checks, and other documents. These documents explain and support the entries on your tax return.

Recordkeeping. Generally, no special kinds of record books are required. However, your books should contain all the information you need to figure your income, deductions, credits, and other items that you have to show on your income tax return. You may want to keep records of your Forms 1099, preproductive expenses, and conservation documents.

Specific information on recordkeeping for farmers exempt from federal excise tax on diesel fuel used in off-highway vehicles is provided under *How to Claim a Credit or Refund*, in Chapter 17.

Travel expenses. You are required to support your expenses for travel in connection with your business, including local travel, gifts, entertainment, and the business use of certain ***listed property***, with adequate records or sufficient evidence to prove your own statements. ***Listed property*** generally includes all passenger automobiles, entertainment, amusement or recreation type property, and computer equipment. For more information on listed property, see Publication 534, *Depreciation*. Adequate records include account books, diaries, trip sheets, or similar items.

Written records. Records that are written at or near the time you incur the expenses are generally considered as adequate evidence. Oral statements or written records reconstructed much later cannot be relied on to support your expenses.

See Publication 463, *Travel, Entertainment, and Gift Expenses*, Publication 534, *Depreciation*, and Publication 917, *Business Use of a Car*, for more information.

Retaining your records. Keep your records that support items of income or expense reported on your tax return until the period of limitations for the tax return runs out. Usually this is the later of:

1) 3 years after the date your return is due or filed, or
2) 2 years after the date the tax is paid.

If you are an employer, you must keep all your employment tax records for at least 4 years after the date the tax becomes due or is paid, whichever is later. This includes copies of Form W–4, *Employee's Withholding Allowance Certificate*, undelivered copies of Form W–2, *Wage and Tax Statement*, and all payroll records. For more detailed information on employment tax records, see *Recordkeeping*, in Publication 937, *Business Reporting*.

Keep records that support your cost basis in property for as long as they are needed to figure the correct cost basis of your original or replacement property (including all capital improvements).

Keep copies of your tax returns. They will help you in preparing future tax returns and in making computations if you later file a claim for refund. They may also be helpful to the executor or administrator of your estate, or to the IRS if your original return is not available.

Illustrated records. A farm income and expense record is illustrated later in Chapter 19.

2. Filing Requirements and Return Forms

If you are a citizen or resident of the United States, single or married, and your gross income for the tax year is at least the amount shown in the category below that applies to you, you must file a 1990 federal income tax return even if no tax is due. This also applies to minor children. Gross income is explained later.

Who must file:

If filing status is:	A return is required if income is at least:
Single	
Under 65	$ 5,300
65 or older	6,100
Head of Household	
Under 65	$ 6,800
65 or older	7,600
Married Filing Jointly	
Both under 65	$ 9,550
One spouse 65 or older	10,200
Both 65 or older	10,850
Not living with spouse at end of year (or on date spouse died)	2,050
Married Filing Separately	
All—regardless of age	$ 2,050
Qualifying Widow(er)	
Under 65	$ 7,500
65 or older	8,150

Dependent's return. If you can claim someone as a dependent on your tax return (for example, your son or daughter), that person must generally file his or her own tax return if he or she:

1) Had only earned income, such as salary or wages, and the total is more than $3,250, or
2) Had only unearned income, such as interest and dividends, and the total is more than $500, or
3) Had both earned and unearned income, and the total is more than $500.

See the instructions that accompany your Form 1040 for more information on who must file a return for 1990.

Self-employed. If you are self-employed, you must file a return if you had net earnings of $400 or more from self-employment, even though you are not otherwise required to file an income tax return. See Chapter 15.

Earned income credit refund. You must also file a return to receive any refund from the earned income credit.

Identification number. You must show your taxpayer identification number (your social security or employer identification number) on all returns, statements, or documents you are required to file. For example, it must be shown on your federal income tax return, your estimated tax payment-voucher, and all information returns, such as Forms 1096 and 1099. A penalty of $5 may be levied for each failure to show the number.

Identification number to use. If you have to file an excise, alcohol, tobacco, firearms, or employment tax return, you should have an employer identification number and use that number on your farm business Schedule F. Otherwise, use your social security number. On your individual income tax return (Form 1040), computation of social security self-employment tax (Schedule SE), and estimated tax payment-voucher (Form 1040–ES), the identification number you should use is your social security number regardless of the number used on your business returns.

If you are married, show social security numbers for both you and your spouse on your Form 1040, whether you file jointly or separately. If you are filing a joint return, list the social security numbers in the same order that you show your first names. Also show both social security numbers on your Form 1040–ES if you make joint estimated tax payments.

Application for identification number. To apply for a social security number, use Form SS–5. If you are under 18 years of age, you must furnish evidence of age, identity, and U.S. citizenship with your Form SS–5. If you are 18 or older, you must appear in person with this evidence at a social security office.

To apply for an employer identification number, use Form SS–4. You can get both these forms from any IRS or social security office.

Estimated Tax and Return Due Date

When you must pay estimated tax and file your return depends on whether you qualify as a farmer. To qualify as a farmer, you must receive at least two-thirds of your total gross income from farming in the current or prior year. ***Gross income is not the same as total income*** shown on line 23 of Form 1040.

Gross Income

The amount of your gross income is used to determine if you must file an income tax return. It is also used to determine if you qualify as a farmer. To see if you qualify as a farmer, first figure the amount of your total gross income and then determine what percentage of this total comes from farming.

Gross income is all income you receive in the form of money, property, and services that is not exempt from tax. It is the total income you receive before allowable deductions. For a business, gross income is total receipts minus cost of goods sold.

Joint return. On a joint return, you must add your spouse's gross income to your own gross income to determine if at least two-thirds of the total is from farming.

Gross income includes:

1) Wages, salaries, tips, etc.,
2) Taxable interest,
3) Dividends,
4) Taxable refunds of state and local taxes,
5) Alimony received,
6) Gross business income from line 7, Schedule C (Form 1040),
7) Capital gains from Schedule D (Form 1040). Use ***only*** column (g). Losses cannot be netted against gains. Add lines 7 and 16, column (g), and subtract the total of lines 5, 12, and 14, column (g),
8) Capital gain distributions reported on line 14, Form 1040,
9) Gains on sales of business property from line 15, Form 1040 (if zero or less, enter zero),
10) Taxable IRA distributions, pensions, annuities, and social security benefits,
11) Gross rental income from line 3, Schedule E (Form 1040),
12) Gross royalty income from line 4, Schedule E (Form 1040),
13) Your taxable net income from an estate or trust (line 36, Schedule E, Form 1040),
14) Income from a REMIC reported on line 38, Schedule E (Form 1040),
15) Gross farm rental income from line 7, Form 4835,
16) Farm income from line 11, Schedule F (Form 1040),
17) Your distributive share of gross income from a partnership,
18) Your pro rata share of gross income from an S corporation,
19) Unemployment compensation,
20) Other income reported on line 22, Form 1040 that is not reported with any of the items listed above.

There is a brief description of forms and schedules later in this chapter.

Gross Income From Farming

Gross income from farming includes:

1) Farm income from line 11, Schedule F (Form 1040),
2) Farm rental income from line 7, Form 4835 (Form 1040),
3) Gross farm income from line 41, Schedule E (Form 1040),
4) Gains from the sale of livestock used for draft, breeding, sport, or dairy purposes reported on Schedule D (Form 1040) or Form 4797.

Farm employees. Wages you receive as a farm employee are not farm income. This includes wages you receive from a farm corporation even if you are a stockholder in the corporation. If all or most of your income is from wages as a farm employee, your employer is usually required to withhold income tax from your wages. You also may have to make estimated tax payments if you do not have enough tax withheld. For more information, see Publication 505, *Tax Withholding and Estimated Tax*.

Farming percentage of gross income. Total your gross income from all sources as shown above. Then total your gross income from farming. Divide your farm gross income by your total gross income to determine what percentage of your gross income comes from farming.

Example 1. James Smith had the following total gross income and farm gross income in 1990:

	Gross Income	
	Total	Farm
axable interest	$43,000	
ividends	500	
ental income (Sch E)	1,500	
arm income (Sch F)	75,000	$75,000
chedule D	5,000	5,000
otals	$125,000	$80,000

Schedule D showed gains from the sale of dairy ows carried over from Form 4797 ($5,000) in ddition to losses from the sale of corporate stock $2,000). Mr. Smith's gross farm income is 64% of is total gross income ($80,000 ÷ $125,000 = 4%). Therefore, he does not meet the farm gross ncome test in 1990. However, he can still qualify s a farmer if at least two-thirds of his gross ncome was from farming in 1989.

Example 2. The facts are the same as xample 1 except that Mr. Smith also received ross farm rental income (Form 4835) of $15,000. his made his total gross income $140,000 and is farm gross income $95,000. He qualifies as a armer in 1990 since at least two-thirds of his ross income is from farming ($95,000 ÷ 140,000 = 67.9%).

Qualified Farmer Due Dates

you received at least two-thirds of your total ross income for 1989 from farming or you eceived at least two-thirds of your total 1990 ross income from farming, you have only one ayment due date for estimated tax—January 15, 991.

Therefore, for your 1990 tax, you may either:

1) Pay all your estimated tax by January 15, 1991, and file your Form 1040 by April 15, 1991, or
2) File your Form 1040 by March 1, 1991, and pay all the tax that is due. You will not have a penalty for not paying estimated tax.

enalty. If you do not pay all your required stimated tax by January 15, 1991, and do not file our return and pay the tax by March 1, 1991, use orm 2210F, *Underpayment of Estimated Tax by armers and Fishermen,* to find out if you owe a enalty. If you owe a penalty but do not file Form 210F and pay the penalty with your return, you ill get a penalty notice from the IRS. You should ay the penalty as instructed by the notice.

Occasionally, you may get a penalty notice even ough you filed your return on time and met the ross income test. If you receive a penalty notice r underpaying estimated tax that you think is in rror, write to the address on the notice and xplain why you think the notice is in error. Include computation, similar to the one in Example 1, howing that you meet the gross income test. Do ot ignore a penalty notice even if you think it is in rror.

iscal years. If you qualify as a farmer but your x year does not start on January 1, you may file our return and pay the tax on or before the first ay of the 3rd month after the close of your tax ear. Or pay your required estimated tax within 15 ays after the end of your tax year. Then file your turn and pay any balance due on or before the 5th day of the 4th month after the end of your tax ear.

onqualified Farmer Due Dates

you did not qualify as a farmer in 1990 because ss than two-thirds of your total gross income as from farming and you do not expect to qualify 1991, you do not qualify for the special stimated tax payments and return due dates. You enerally must make quarterly estimated tax ayments on April 15, June 17, and September , 1991, and on January 15, 1992. You must file ur return by April 15, 1992.

For more information on estimated taxes and related penalties, see Chapter 2 in Publication 505, *Tax Withholding and Estimated Tax.*

Other Filing Information

If the last day for filing your return or making a payment falls on a Saturday, Sunday, or legal holiday, your return or payment will be on time if it is filed or made on the next day that is not a Saturday, Sunday, or legal holiday.

Automatic extension of time to file Form 1040. If you do not choose to file your return by March 1, 1991, the due date for your 1990 return will be April 15, 1991. However, you can get an automatic 4-month extension of time to file your return. Your Form 1040 would then be due by August 15, 1991. To get this extension, file Form 4868, *Application for Automatic Extension of Time to File U.S. Individual Income Tax Return,* by April 15, 1991. For more information, see the instructions for Form 4868.

This extension ***does not*** extend the March 1 filing date for farmers who did not make an estimated tax payment and who want to avoid an estimated tax penalty. Therefore, if you did not make an estimated tax payment by January 15 and you file your tax return after March 1, you will be subject to a penalty for underpaying your estimated tax even if you filed Form 4868.

Return Forms

When filing your income tax return, arrange your forms and schedules in the correct order using the sequence numbers located in the right-hand corner of the form under the year. Attach all other statements or attachments last, even if they relate to another form or schedule. Do not attach these other statements to the related form or schedule. Some of these forms and schedules are illustrated in Chapter 19.

The following forms and schedules are used by farmers.

Form 1040. This form is your income tax return. You must list your taxable income from all sources on Form 1040, including your profit or loss from farming operations as determined on Schedule F (Form 1040). You also figure your tax on this form.

Schedule A (Form 1040). This schedule is used to list your nonbusiness itemized deductions.

Schedule B (Form 1040). This schedule is used to report your interest and dividend income if over $400.

Schedule C (Form 1040). This schedule is used to list income and deductions and to determine the net profit or loss from a nonfarm business.

Schedule D (Form 1040). This schedule is used to report gains and losses from sales of capital assets.

Schedule E (1040). This schedule is used to report income or losses from rents, royalties, partnerships, estates, trusts, and S corporations.

Schedule F (Form 1040). This schedule is used by farmers filing on either the cash or the accrual method. List all your farm income and deductions and determine your net farm profit or loss on this schedule.

Schedule SE (Form 1040). This schedule is used to figure your social security self-employment tax. See Chapter 15.

Form 3800. Form 3800, *General Business Credit,* is used to figure your general business credit, which is a combination of your investment credit, jobs credit, alcohol fuel credit, research credit, and low-income housing credit. If you have only one of these credits, no carryovers, and no credit is from a passive activity, file only the applicable credit form.

Form 4136. Form 4136, *Computation of Credit for Federal Tax on Fuels,* is used to figure the credit for federal tax on gasoline and special fuels. See Chapter 17.

Form 4684. Form 4684, *Casualties and Thefts,* is used to report gains and losses from casualty and theft of business and personal-use property.

Form 4797. Form 4797, *Sales of Business Property,* is used to report gains and losses from the sale or exchange of business property and from certain involuntary conversions.

Form 2210F. Form 2210F, *Underpayment of Estimated Tax by Farmers and Fishermen,* is used by farmers to figure any underpayment of estimated tax and the underpayment penalty.

Form 6251. Form 6251, *Alternative Minimum Tax—Individuals,* is used to figure the alternative minimum tax. See Chapter 14.

Form 3468. Form 3468, *Computation of Investment Credit.* The investment credit is generally repealed, but see Chapter 9 for any exceptions that may apply to you.

Form 4255. Form 4255, *Recapture of Investment Credit,* is used to figure the tax from the recapture of investment credit.

Form 4562. Form 4562, *Depreciation and Amortization,* is used to explain the deductions for depreciation and amortization on your tax return.

Form 4835. Form 4835, *Farm Rental Income and Expenses,* is used to report farm rental income based on crops or livestock produced by the tenant, if the landlord did not materially participate in the operation or management of the farm.

Other Forms

The following forms may also be filed by farmers in certain situations.

Form 1065. Form 1065, *U.S. Partnership Return of Income,* should be filed for all farm partnerships. See *Partnerships* later in this chapter.

Form 1120. Form 1120, *U.S. Corporation Income Tax Return,* is filed by ordinary corporations. ***Form 1120–A,*** a short version of Form 1120, can be used by many small corporations instead of Form 1120. See *Corporations* later in this chapter.

Form 1120S. Form 1120S, *U.S. Income Tax Return for an S Corporation,* is used by S corporations. See *S Corporations,* later in this chapter.

Form 943. Form 943, *Employer's Annual Tax Return for Agricultural Employees,* must be filed on or before January 31 of the following year if you were required to withhold and pay social security tax, and withheld income tax on farm labor wages paid during the calendar year. If you deposited all your taxes by January 31, you may file Form 943 as late as February 10.

Form 8109. Form 8109, *Federal Tax Deposit Coupon,* is used to deposit employment taxes and all other taxes that are deposited. In general, you must deposit income tax withheld and both employer and employee social security taxes that total $500 or more. The IRS will send you a coupon book when you apply for an employer identification number. See Chapter 16.

Form 940. Form 940, *Employer's Annual Federal Unemployment (FUTA) Tax Return,* must be filed on or before January 31 of the following year if you were subject to FUTA tax. If you deposited all your tax by January 31, you may file Form 940 as late as February 10. ***Form 940–EZ*** is a simplified version of Form 940. See Chapter 16.

Form W–2. Form W–2, *Wage and Tax Statement,* must be prepared for each employee to whom you paid any amount for services, including any payment you made that was not in cash, if you are in a trade or business. Show, in the space marked *Wages, tips, other compensation,* the total amount paid to the employee. Send Copy A of each Form W-2 to the Social Security Administration with a completed Form W-3, *Transmittal of Income and Tax Statements*, on or before the last day of February. Copies B and C of Form W-2 must be given to the employee. See Chapter 16.

Form 2290. Form 2290, *Heavy Vehicle Use Tax Return*, must be filed if you have a truck or truck tractor registered in your name that (1) is a highway motor vehicle, (2) is required to be registered for highway use, (3) is actually used at least once on a public highway, and (4) has a gross taxable weight of at least 55,000 pounds. See Publication 349, *Federal Highway Use Tax on Heavy Vehicles*.

Form 8645. Form 8645, *Soil and Water Conservation Plan Certificate*, is used to figure amounts spent to conserve soil or water. To be deductible, these expenses must be consistent with an approved conservation plan. See the instructions for Schedule F (Form 1040).

Form 8822. Form 8822, *Change of Address*, should be used to notify IRS of a change in your mailing address. Be sure to include your suite, room, or other unit number. If you are changing both your home and business addresses, complete two separate forms. However, individuals who are also household employers and file Form 942 can use one form. Send the form to the Internal Revenue Service Center for your old address.

Form 8824. Beginning in 1990, if you have a like-kind exchange, you must file Form 8824, *Like-Kind Exchanges*, in addition to Schedule D (Form 1040) or Form 4797. See Chapter 10.

Information Returns

Information returns are forms that provide information required by the IRS other than amounts of tax due. There are many information forms, including Form W-2 previously discussed, but this discussion is restricted to Form 1099–INT, Form 1099–MISC, and Form 1096.

If you make total payments of $600 or more during the calendar year to another person, other than a corporation, in the course of your farm business, you must file information returns to report these payments for the calendar year. You report interest payments, including interest paid on installment sale contracts, of $600 or more on Form 1099–INT. Payments of $600 or more made for rents, commissions, fees, prizes, awards, independent contractors, and other payments and compensation, including payments to subcontractors and payments for services provided to you by nonemployees, are reported on Form 1099–MISC. Payments of $10 or more for royalties are reported on Form 1099–MISC.

Payments for merchandise, freight and similar charges, and for rental payments to real estate agents need not be reported. However, if you pay a contractor who is not a dealer in supplies for both supplies and services, you must report both the payment for supplies and for services. Payments for compensation to employees are reported on Form W-2, not on any of the Forms 1099.

You also use Forms 1099 to report to the payee and to the IRS payments you made that were subject to backup withholding and the amounts you withheld. See Chapter 16.

Preparation of returns. You must prepare separate copies of Form 1099–INT and Form 1099–MISC for each person. One copy of the form must be filed with the IRS. Each person who received payment from you must be given a statement (or copy of the form) by January 31 of the following year.

You must use a separate transmittal, Form 1096, *Annual Summary and Transmittal of U.S. Information Returns*, for each different type of form. Because all these forms are read by machine, there are very specific instructions for their preparation and submission. You may be subject to a $50 penalty for each incorrectly filed document. Instructions for completing these forms are in a booklet titled, *1990 Instructions for Forms 1099, 1098, 5498, 1096, and W–2G.*

Penalties. There is an escalating time-sensitive penalty rate applied to information returns as follows:

1) Correct information returns filed within 30 days after the due date, $15 each, with a cap of $75,000.
2) Correct information returns filed after the 30-day period but before August 1, $30 each, with a cap of $150,000.
3) Information returns filed after August 1, or never filed, $50 each, with a cap of $250,000.

Small businesses (gross receipts of $5 million or less) are charged the same per document penalty, but the caps are lowered to $25,000, $50,000, and $100,000.

Partnerships

A partnership is the relationship between two or more persons who join together to carry on a trade or business, including farming. Each partner contributes in some way—money, property, labor, or skill—and shares profits and losses in agreed proportions.

A syndicate, group, pool, joint venture, or other unincorporated organization that carries on any business, financial operation, or venture is also a partnership for tax purposes, unless it can be classified as a corporation, a trust, or an estate.

Family partnerships. Members of the same family may, and often do, form valid partnerships. For instance, a husband and wife or parents and children may conduct a farming enterprise through a partnership. To be recognized as a partnership for federal tax purposes, a partner relationship must be established. Merely doing chores, helping with the harvest, or keeping house and cooking for the family and hired help does not establish a partnership. If a husband and wife are partners in the operation of a farm or other business, they should report their partnership income on a partnership return, Form 1065.

Co-ownership and sharing expenses. Mere co-ownership of property that is maintained and leased does not constitute a partnership. For example, if an individual owner or tenants-in-common of farm property lease that property for cash rental or a share of the crops, a partnership is not necessarily created by the leasing. However, tenants-in-common may be partners if they actively carry on a farm or other business operation and share its profits and losses. A joint undertaking merely to share expenses is not a partnership.

Filing Requirements

All partnerships should file a return on Form 1065, *U.S. Partnership Return of Income*. This is an information return showing the income and deductions of the partnership, the name and address of each partner, and the amount of each partner's distributive share of income, gain, loss, deductions, credits, etc. A return must be filed for each tax year of the partnership even though the partnership has no income. However, a return is not required before the first tax year the partnership has income or deductions. A penalty is assessed against the partnership if the partnership is required to file a partnership return and:

1) Fails to file the return on time, including extensions, or
2) Files a return that fails to show all the infor tion required.

The penalty is $50 a partner per month for a m mum of 5 months.

However, a partnership does not have to pay the penalty if it can show reasonable cause for failure to file a return. A family farm partnership with 10 or fewer partners will usually be considered to meet this requirement if it can show tha all partners have fully reported their shares of a partnership items on their timely filed income ta returns. In addition, the partnership must have r foreign or corporate partners, and each partner' proportionate share of each partnership item m be the same.

Schedule F (Form 1040). Use Schedule F (Form 1040) to report the farm partnership profi or loss. This schedule should be filed with Form 1065. The profit or loss shown on Schedule F, adjusted for amounts to be reported on ***Schedu*** ***K–1*** and ***Schedule K*** of Form 1065, is entered line 5 of Form 1065. Each partner's distributive share of partnership items, such as ordinary income or loss, capital gain or loss, net earning from self-employment, etc., is entered on Sched ule K–1 of Form 1065. Fill in all other schedules on Form 1065 that apply to you.

Partner's distributive share. Each partner's d tributive share of partnership income, gain, loss, etc., must be included on that partner's tax retur even though the items were not distributed. No is payable on the return of a partnership.

Social security self-employment tax. Unless you are a limited partner, your distributive share income from a partnership is self-employment income. The social security self-employment tax of a member of a partnership engaged in farmin is discussed in Chapter 15.

Ending Partnership

When you create a partnership, you do not usua recognize any gain or loss on contributions of money or property you make to the partnership. However, you will usually have to recognize gain or loss when you end the partnership.

You may be able to avoid recognizing gain or loss on ending the partnership if you buy out you partners or change to a corporation status.

For more information on partnerships, see Publication 541, *Tax Information on Partnerships*

Corporations

A corporation, for federal income tax purposes, includes associations, joint stock companies, trusts, and partnerships that actually operate as associations or corporations.

Organizations that are unincorporated and hav certain corporate characteristics are classified a associations and taxed as corporations. These organizations must have associates and be orga ized to carry on business and divide any gains. They must also have a ***majority*** of the following characteristics:

1) Continuity of life,
2) Centralization of management,
3) Limited liability, and
4) Free transferability of interests.

However, other factors may also be significant in classifying an organization as an association. An organization will be treated as an association if it corporate characteristics make it more nearly resemble a corporation than a partnership or tru The facts in each case determine whether or not these characteristics are present.

Corporate tax. Corporate profits are normally taxed to the corporation. When the profits are di tributed as dividends, the dividends are taxed to the shareholders.

In figuring its taxable income, a farm corporation nerally takes the same deductions that a ncorporate farmer would claim on Schedule F orm 1040). Corporations are also entitled to ecial deductions.

orming a corporation. A corporation is formed a transfer of either money, property, or both, by ospective shareholders in exchange for capital ock in the corporation.

If money is exchanged for stock, no gain or loss realized by the shareholder or corporation. The ock received by the shareholder has a basis qual to the money transferred to the corporation the shareholder.

If property is exchanged for stock, it may be ther a taxable or nontaxable exchange.

ling requirements. Corporations file Form 120, *U.S. Corporation Income Tax Return*, or orm 1120–A, *U.S. Corporation Short-Form ncome Tax Return.* A corporation must file an come tax return unless it has dissolved. This pplies even if it ceased doing business and isposed of all its assets except for a small sum of ash retained to pay state taxes to keep its corporate charter.

For more information on corporations, see ublication 542, *Tax Information on Corporations.*

S Corporations

qualifying corporation may choose to be generlly exempt from federal income tax. Its shareolders will then include in income their share of e corporation's separately stated items of ncome, deduction, loss and credit and their share f nonseparately stated income or loss. A corpoation that makes this choice is known as an S orporation. Although it generally will not be liable or federal income tax, an S corporation may have o pay a tax on excess passive investment ncome, a tax on certain capital gains, a tax on uilt-in gains, or the tax from recomputing a prior ear's investment credit. In addition, beginning in 990, an S corporation may have to make quarerly estimated tax payments.

An S corporation files its return on Form 1120S, *U.S. Income Tax Return for an S Corporation.*

To make this election, a corporation, in addition o other requirements, must not have more than 35 shareholders. Each of its shareholders must also consent to the election.

For more information, see Publication 589, *Tax Information on S Corporations.*

3. Accounting Periods and Methods

Each taxpayer (business or individual) must figure taxable income on the basis of an annual accounting period. Each taxpayer must also use a consistent accounting method that accurately accounts for income and expenses. For more detailed information, such as how to change an accounting period or method, see Publication 538, *Accounting Periods and Methods.*

Accounting Periods

The term "tax year" is the annual accounting period you use for keeping your records and reporting your income and expenses. The accounting periods you can use are:

- A calendar year, or
- A fiscal year.

You adopt a tax year when you file your first income tax return. You must adopt your first tax year by the due date (not including extensions) for filing a return for that year.

Calendar tax year. If you adopt the calendar year for your annual accounting period, you must maintain your books and records and report your income and expenses for the period from January 1 through December 31 of each year.

If you filed your first return using the calendar tax year, and you later begin business as a farmer or become a partner in a partnership or a shareholder in an S corporation, you must continue to use the calendar tax year unless you get permission to change. You must report your income from all sources, including your farm, salaries, partnership income, and dividends, using the same tax year.

You must adopt the calendar tax year if:

1) You do not keep adequate records,
2) You have no annual accounting period, or
3) Your present tax year does not qualify as a fiscal year.

Fiscal tax year. A regular fiscal tax year is 12 consecutive months ending on the last day of any month except December. If you adopt a fiscal tax year, you must maintain your books and records and report your income and expenses using the same tax year.

Partnerships and S corporations. Special restrictions apply to the tax year that may be adopted by partnerships and S corporations. See *Partnerships, S Corporations, and Personal Service Corporations* in Publication 538.

Accounting Methods

An accounting method is a set of rules used to determine when and how income and expenses are reported. The term "accounting method" includes not only the overall method of accounting you use, but also the accounting treatment you use for any item. You must file your return using the same method you use for your tax records.

You choose your accounting method when you file your first tax return. However, you cannot use the crop method, discussed later, even for your first return, unless you get consent from the IRS. After you file your first return, if you want to change your accounting method, you must first get consent from the IRS. The methods you may use are:

1) Cash method,
2) Accrual method,
3) Special methods of accounting for certain items of income and expenses, and
4) Combination (hybrid) method using elements of (1), (2), or (3).

If you have more than one business, you can use a different accounting method for each business, provided you keep a complete and separate set of books and records for each business.

Cash versus accrual methods. A comparison of the cash and accrual methods of accounting is illustrated in the following examples. These two methods are explained in greater detail, later.

Example 1. You are a farmer who uses the accrual method. You keep your books on the calendar year basis. You sell some grain in December 1990. You are not paid until January 1991. Both the selling price and the cost incurred in 1990 to produce the grain must be included on your return for tax year 1990. This will result in the profit or loss on the sale being reported for the year all events occurred that fix the right to receive income from this transaction, and the profit or loss on the transaction can be determined with reasonable accuracy.

Example 2. Assume in Example 1 that you used the cash method and that there was no constructive receipt of the selling price in 1990. Under this method, the selling price is included in income for 1991, the year payment is received. The cost of producing the grain is deductible in the year it is paid.

Special methods. There are special methods of accounting for certain items of income and expenses. One of these methods is the ***crop method.*** Methods of accounting for depreciation, amortization, and depletion are explained in Chapter 8. Methods of accounting for installment sales are explained in Chapter 12.

Crop method. If you do not complete harvesting and disposing of your crops in the same tax year you plant them, you may, with consent from the IRS, choose to use the crop method. Under this method, the entire cost of producing the crop, including the expenses of seed or young plants, must be deducted in the year the income from the crop is realized. This method cannot be used for timber or any commodity covered by the uniform capitalization rules.

Combination (hybrid) method. Any combination of cash, accrual, and special methods of accounting can be used if the combination clearly shows income and is consistently used. You may specifically use the accrual method for purchases and sales and the cash method for all other items of income and expenses. The following restrictions do apply:

1) If you use the cash method for figuring your income, you must use the cash method for reporting your expenses.
2) If you use the accrual method for reporting your expenses, you must use the accrual method for figuring your income.

Any combination that uses the cash method is treated as the cash method.

Cash Method

The cash method is used by most farmers because they find it easier to keep cash method records. However, if you use inventories to figure your gross income, you must use the accrual method for your purchases and sales. The cash method cannot be used by certain farm corporations and partnerships, and by all tax shelters. See *Accrual Method*, later.

Income

With the cash method, you include in your gross income all items of income you actually or constructively receive during the year. If you receive property or services as income, you must include the amount of their fair market value in income.

Constructive receipt. You have constructive receipt of income when an amount is credited to your account or made available to you without restriction on the time or manner of payment. You do not need to have possession of it. The receipt of a check is constructive receipt of money, even though you do not deposit or cash it during the tax year you receive it. An amount credited to your account at a bank, store, grain elevator, etc. is constructively received in the year it is credited.

If you sell any items under a deferred payment contract that calls for payment the following year, there is no constructive receipt in the year of sale.

Example. You are a farmer who uses the cash method and a calendar year. You sell grain in December 1990 under a bona fide arm's-length contract that calls for payment during 1991. You include the proceeds of the sale in your 1991 gross income, since that is the year payment is received. However, if under the terms of the contract you have the right to the proceeds from the buyer at any time after the grain is delivered, you must include the selling price in your 1990 income, regardless of when you receive actual payment.

Items included in income. Your gross income for the tax year includes:

1) The amount of cash and the value of merchandise or other property you receive during the tax year from the sale of raised livestock, poultry, vegetables, fruits, etc.
2) Your profit from the sale of all other livestock or other items. To find your profit from the sale of livestock or other items purchased, deduct the cost or other basis of the property, plus selling expenses, from the selling price. The cost of items you purchased for resale is not usually deducted in the year paid unless the payment and the sale occur in the same year. However, see Chapter 5 for when to deduct the cost of chickens, seeds, and young plants.
3) All amounts you receive from breeding fees, fees from rent of livestock, machinery, or land, and other incidental farm income.
4) All subsidy and conservation payments you receive that must be considered income.
5) Your gross income from other sources.

Crop insurance proceeds may be reported in income in the year following the year of loss under certain conditions. See *Crop Insurance and Disaster Payments* in Chapter 4.

Expenses

Farm business expenses are deductible only in the tax year they are paid. However, certain prepaid expenses for supplies may only be deducted when the supplies are actually used or consumed. See Chapter 5 for more information.

Inventories are not used to figure income on the cash method. However, if you are subject to the uniform capitalization rules (discussed later), you may use the farm-price method or the unit-livestock method to account for the costs of any plant or animal, even if the plant or animal is not held or treated as inventory property. See *Items purchased for resale* in Chapter 5.

Accrual Method

Under the accrual method of accounting, income is generally reported in the year earned, and expenses are deducted or capitalized in the year incurred. The purpose of the accrual method of accounting is to match your income and expenses in the correct year.

Income

All items of gross income from farming operations are included in your gross income when you earn them, even though you may receive payment in another tax year. All events that fix your right to receive the income must have happened and you must be able to figure the amount with reasonable accuracy.

Items to include in income. If you use the accrual method, you must use inventories to figure your gross income. Increases and decreases in inventory values of livestock, crops, produce, feed, etc., at the end of the year as compared with the beginning of the year are reflected in figuring your gross income. Complete inventories of these items are required for reporting on the accrual method. For more information on inventories, see *Farm Inventories*, later in this chapter. To figure gross income on the accrual method, ***add*** the following items:

1) The selling price of all livestock and products you sell during the year,
2) The inventory value of livestock and products you have on hand that are not yet sold at the end of the year,
3) All miscellaneous items of income you earn during the year, such as breeding fees, fees from the rent of livestock, machinery, or land, or other incidental farm income,
4) Any subsidy or conservation payments you receive that must be considered income, and
5) Your gross income from all other sources.

Then ***subtract*** the total of the following:

1) Inventory value of the livestock and products you had on hand at the beginning of the year, and
2) The cost of any livestock or products you purchased during the year.

Expenses

You deduct farm business expenses in the tax year you become liable for them, whether or not you pay them in that year, unless they are costs subject to the uniform capitalization rules.

You generally cannot deduct farm business expenses until economic performance occurs. Economic performance generally occurs as the property or services are provided, even if you have not paid the expenses. An exception for recurring items allows certain expenses to be treated as incurred in a tax year even though economic performance has not occurred. See Publication 538.

Accrual Method Required

The accrual method is required for certain farm corporations and partnerships, and all tax shelters, including farming syndicates. Corporations engaged in farming, and partnerships engaged in farming if a corporation is a partner, are required to use the accrual method of accounting, unless they are excepted from the rule as described later in *Accrual Method Not Required*.

Tax shelter. A tax shelter is a farming syndicate, or:

1) A partnership or other entity,
2) Any investment plan or arrangement, or
3) Any other plan or arrangement, if the principal purpose of the partnership, entity, plan, or arrangement is the avoidance or evasion of federal income taxes.

Farming syndicate. A farming syndicate may be a partnership, any other noncorporate enterprise, or an S corporation engaged in the trade or business of farming if:

1) Interests in the partnership or enterprise were ever offered for sale in any offering required to be registered with any federal or state agency having authority to regulate the offering, or
2) More than 35% of the losses during any period are allocable to limited partners or limited entrepreneurs.

A limited partner is one whose personal liability for partnership debts is limited to the amount of money or other property the partner contributed or is required to contribute to the partnership.

A limited entrepreneur is a person who has an interest in an enterprise other than as a limited partner and who does not actively participate in the management of the enterprise.

Accrual Method Not Required

The accrual method of accounting is not required to be used by:

1) S corporations,
2) Corporations whose gross receipts for each tax year beginning after 1975 are $1,000,000 or less,
3) Corporations, or partnerships with corpor partners, whose trade or business is oper a nursery or sod farm or raising or harvest trees, other than fruit and nut trees, and
4) Certain family farm corporations.

A family farm corporation can use the cash method of accounting if its annual gross recei for all tax years beginning after 1985 are $25,000,000 or less, and it qualifies as one of following:

1) Corporations in which at least 50% of the total combined voting power of all classe stock entitled to vote and at least 50% of total number of shares of all other classe stock of the corporation are owned by me bers of the same family.
2) Corporations if, on October 4, 1976, and s then, members of two families own, direct indirectly, at least 65% of the total combin voting power of all classes of stock entitle vote and at least 65% of the total number shares of all other classes of stock of the corporation.
3) Corporations if, on October 4, 1976, and s then, members of three families own, dire or indirectly, at least 50% of the total combined voting power of all classes of st entitled to vote and at least 50% of the tot number of shares of all other classes of st and substantially all of the remaining stock owned by corporate employees or by their family members or by a tax-exempt emplo ees' trust for the benefit of the corporation employees.

Note: If a corporation (other than an S corp ration) is also engaged in a nonfarming busine activity, the cash method cannot be used for th activity if the average annual gross receipts for 3 prior tax years are more than $5 million. For purpose, the term "farming business" does no include the processing of commodities or prod beyond those activities normally incident to the growing, raising, or harvesting of the product. F example, the processing of grain to produce b and cereal to sell is not a farming business.

Farm Inventories

If you use the accrual method, you must use a inventory to figure your gross income. You sho keep a complete record of your inventories as part of your farm records. This record should s your inventory by actual count or measuremen should also show all the factors that enter into valuation, including quality and weight if they a factors.

Your inventory should include all unsold item the end of the tax year, whether raised or purchased, that are held for sale or for use as fee seed, etc.

Hatchery business. If you are in the hatcher business, you must include eggs in the proces incubation in your inventory.

Products held for sale. All harvested and pu chased farm products held for sale or for feed seed, such as grain, hay, ensilage, concentrat cotton, tobacco, etc., must be included in inventory.

Supplies. You must inventory supplies unless they can be deducted in the year of purchase.

Growing crops. You generally are not require to inventory growing crops. However, if your cr preproductive period is more than 2 years, see *Uniform Capitalization Rules*, in Chapter 7.

Fur-bearing animals. If you are in the busine of breeding and raising chinchillas, mink, foxes other fur-bearing animals, you are a farmer and such animals are livestock. You may, therefore e any of the inventory and accounting methods cussed in this chapter.

iform capitalization rules. You may have to pitalize or include in inventory the costs of sing plants that have a preproductive period of re than 2 years. You cannot take a current duction for costs incurred during the eproductive period. The uniform capitalization es are explained in Chapter 7.

Required to use accrual method. If you are quired to use an accrual method of accounting, u are subject to the uniform capitalization rules en if the preproductive period of raising a plant 2 years or less. If you are required to use the crual method, all animals are subject to the uniform capitalization rules, regardless of age or if animals are held primarily for slaughter.

ventory Valuation Methods

e methods generally available for the valuation your farm inventories include: cost, the lower of st or market, and the farm-price method. In dition to these methods, livestock may be ventoried under the unit-livestock-price method.

Costs required to be allocated under the unim capitalization rules may be determined using ventory methods, such as the farm-price method the unit-livestock-price method by any farmer d for any plant or animal, even if the plant or imal is not held or treated as inventory property the farmer.

rm-price method. Under this method, each m, whether raised or purchased, is valued at the arket price less the estimated direct cost of disposition. Market price means the current price at e nearest market in the quantities you usually ll. Cost of disposition includes broker's mmission, freight and hauling to market, and her marketing costs.

If this method is used, you must use it for the tire inventory, except that your livestock may be ventoried on the unit-livestock-price method.

nit-livestock method. Under this method, livestock is grouped or classified according to kind d age, and a standard unit price is used for ch animal within a class or group. This method cognizes the difficulty of establishing the exact sts of producing and raising each animal, but e unit prices assigned should reasonably proximate the normal costs incurred. Unit prices d classifications are subject to approval by the S on examination of your return. You cannot ake any changes to your classifications or unit ices without consent of the IRS.

All raised livestock must be included in ventory if this method is used, regardless of hether held for sale or for draft, breeding, dairy, sporting purposes. This method accounts only r an increase in the cost of raising an animal to aturity. It does not provide for any decrease in e market value of an animal after it reaches aturity. In addition, this method does not require e inventory of hay grown by a cattle raiser solely r feeding a herd.

Animals sold or lost should not be included in e year-end inventory. If your records do not ow which animals were sold or lost, the first animals acquired are considered sold or lost. Thus, e animals on hand at the end of the year are onsidered the ones most recently acquired.

Purchased animals. All livestock purchased imarily for sale must also be included in ventory. Livestock purchased for draft, breeding, airy, or sporting purposes may be included in ventory or treated as depreciable assets. However, you must be consistent from year to year gardless of the practice you have chosen. You ay not change your practice unless you get the onsent of the IRS.

Animals purchased after maturity must be inventoried or capitalized at their purchase price. If the nimals purchased are not mature at the time of urchase you must modify the annual standard price to reflect the period during the tax year when you bought the animal. This applies to all taxpayers for tax years beginning after December 31, 1987.

Simplified production method. If you use the unit-livestock method, you can elect to use the simplified production method explained in section 263A–1T(b)(5) of the Income Tax Regulations and Notice 88–86, 88–2 C.B. 401. A change to or from the simplified production method is a change in accounting method, explained next.

Change in Accounting Method

When you file your first return, you may choose any appropriate accounting method, except the crop method, discussed earlier, without consent from the IRS. The method you choose must clearly show your income and be used from year to year. After that, if you want to change your accounting method, you must first get consent from the IRS, unless you qualify under the exceptions described later under *Consent not required.*

A change in your accounting method includes a change not only in your overall method, such as from the cash to the accrual method or vice versa, but also in your treatment of any material item, such as in figuring depreciation.

Consent not required. You do not need prior approval from the IRS to change your accounting method in the following situations:

1) You valued your livestock inventory at cost, or at the lower of cost or market, and you change to the unit-livestock method, or
2) You are a family farm corporation, as described earlier under *Accrual Method Not Required,* and you must change to the accrual method because your annual gross receipts are more than $25,000,000.

Family farm corporations. If you must change to the accrual accounting method because your annual gross receipts are more than $25,000,000, you must establish a suspense account to reduce your section 481 adjustments that must be included in income. See section 447(i) of the Internal Revenue Code for information about suspense accounts.

Consent required. You need prior approval from the IRS to change your accounting method in the following situations:

1) A change from the cash to the accrual method or vice versa,
2) A change in the method or basis used to value inventories,
3) A change involving the adoption of any other specialized method of computing net income, such as the crop method, or a change in the use of this specialized method,
4) A transfer of draft, dairy, or breeding animals from inventory to a fixed asset account, and
5) A case where the taxpayer has chosen to report loans from the Commodity Credit Corporation as income in the year received and now wants to change to a different method.

How to secure consent. You must file a current Form 3115, *Application for Change in Accounting Method.* A user fee of $500 must be sent with the application.

In most cases, you must file the application within the first 180 days of the tax year for which you request the change. However, if you want to change your method to report Commodity Credit loans, you must request the application of Revenue Procedure 83–77, 1983–2 C.B. 594. This procedure automatically extends the 90–day filing period for Commodity Credit loans to 180 days. See *Commodity Credit loans* in Chapter 4.

You must furnish all applicable information requested on the form. You may also be required to provide additional information.

4. Farm Income

You receive income from many sources. Where you report income on your tax return depends on the source of that income. You must report your income no matter what its source, unless it is excluded by law. For more information, see Publication 525, *Taxable and Nontaxable Income,* and the instructions for Form 1040.

This chapter discusses income that you report on Schedule F, *Farm Income and Expenses.* Do not confuse this income with the definition of gross farm income for estimated tax purposes (Chapter 2), soil and water conservation expenses (Chapter 6), or self-employment tax (Chapter 15).

Schedule F Farm Income

Income from farming that you report on Schedule F includes amounts you receive from cultivating the soil or raising or harvesting any agricultural commodities. This includes income from the operation of a stock, dairy, poultry, fish, bee, fruit, or truck farm, plantation, ranch, nursery, orchard, or oyster bed. It also includes income you receive in the form of crop shares if you materially participate in the production (see *Landlord Participation in Farming* in Chapter 15).

Income reported on Schedule F does ***not*** include:

1) Gains from sales of farmland or depreciable farm equipment,
2) Gains from sales of livestock held for draft, breeding, sport, or dairy purposes,
3) Income received by a custom grain harvester who performs harvesting and hauling operations, with his or her own equipment and personnel, on farms that the harvester neither owns, rents, or leases.

This chapter discusses some of the kinds of income you might have because you are in the farming business. Report the income from your farm on Schedule F (Form 1040). This schedule is used to figure the net profit or loss from regular farming operations. Gains and losses from the sale of farming assets, such as machinery or farmland, are discussed in Chapters 10 and 11. Gains and losses from casualties, thefts, and condemnations are discussed in Chapter 13.

Accounting method. The rules discussed in this chapter, as elsewhere in this book, assume that you use the cash method of accounting. Under the cash method, you report income when you receive it. However, you may be considered to have received income even though it is not yet in your possession. See *Constructive receipt* under *Cash Method* in Chapter 3.

If you use an accrual method of accounting rather than the cash method, you may have to make modifications to the rules in this chapter. See *Accrual Method* in Chapter 3.

Livestock and Produce

When you sell the produce or livestock (including poultry) you raise on your farm, any money you receive and the fair market value of any property you receive are ordinary income. Produce includes all products of your farming business except livestock. Your profit from the sale of produce or livestock you bought for resale is also ordinary income. Report these amounts on Schedule F in the year you receive payment. Your profit from the sale of produce or livestock bought for resale is the difference between your basis in the produce or livestock and any money plus the fair market value of any property you receive for the produce.

Sales of livestock held for draft, breeding, dairy, or sporting purposes may result in ordinary gains or losses or in capital gains or losses, depending on the circumstances. In either case, these sales should always be reported on Form 4797 instead of Schedule F. Animals you do not hold primarily for sale are considered business assets of your farm. See Chapter 10.

Sales by an agent. The net proceeds from the sale of your produce or livestock by someone acting as your agent must be reported in the year the agent receives payment, even if your arrangement with the agent is that you will not be paid until a later year. However, see *Constructive receipt* in Chapter 3.

Advance payments. If you receive advance payments (other than Commodity Credit loans) on the sale of your produce, or livestock held primarily for sale, include the payments in income in the year you receive them. If at a later date you receive an additional amount, include it in income when you receive it. However, you can choose to include all payments in income in the year you make the sale even if you have not received all payments in that year.

Drought Sales

You may elect to postpone for 1 year reporting the gain from a sale of livestock, including poultry, if the sale was due to drought conditions. This election applies to all livestock held for sale, whether raised or bought for resale. It also applies to livestock used for draft, breeding, dairy, or sporting purposes regardless of the time the livestock were held. A drought sale of livestock (other than poultry) held for draft, breeding, or dairy purposes may qualify as an involuntary conversion, regardless of how long you owned the animals. If you can treat a disposition of livestock as an involuntary conversion and you replace the livestock in a timely manner with qualified replacement property, you may defer gain from the involuntary conversion until you dispose of the replacement livestock. See Chapter 13 for more information on involuntary conversions.

If, because of drought conditions, you sell more animals than if you followed your usual business practice, you may elect to include the gain from the sale of the additional animals in your income next year instead of this year, provided the following conditions are met:

1) Your principal business is farming,
2) You use the cash method of accounting,
3) You can show that, under your usual business practices, the sale would not have occurred this year except for the drought, and
4) The drought resulted in an area being designated as eligible for assistance by the federal government.

Sales made before the area became eligible for federal assistance still qualify, as long as the drought that caused the sale also caused the area to be designated as eligible for federal assistance. The designation can be made by the President, the Department of Agriculture (or any of its agencies), or by other federal agencies.

Usual business practice. The number of animals you would have sold if you followed your usual business practice in the absence of drought will be determined in light of all the facts and circumstances. If you have not yet established a usual business practice, the usual business practices of similarly situated farmers in your general region will be relied on.

Drought sales in successive years. If you make this election in successive years, the following special rules prevent your first election from adversely affecting your second election:

1) Do not include the amount deferred from the earlier year to the next year as received from the sale or exchange of livestock in the next year in figuring the amount to be postponed. See *Amount to be postponed*, later, which describes the total income from livestock sales as a factor in the computation.
2) To determine your normal business practice, exclude any earlier year for which you made this election.

Connection with drought area. The livestock does not have to be raised in a drought area or the sale take place in a drought area to qualify for this postponement. However, the sale must occur solely because of drought conditions that affected the water, grazing, or other requirements of the livestock so that the sale became necessary.

Amount to be postponed. You must make the election separately for each generic class of animals—for example, hogs, sheep, cattle. You must also figure separately the amount to be postponed for each class of animals. Do not make a separate election solely because of the animal's age, sex, or breed.

Follow these steps to figure the amount to be postponed for each class of animals:

1) Divide the total income realized from the sale of all livestock in the class during the tax year by the total number sold, and
2) Multiply the result in (1) by the excess number sold solely because of drought.

Example. You are a calendar year taxpayer, and you normally sell 100 head of beef cattle a year. As a result of drought, you sell 135 head during 1990. You realize $35,100 from the sale. On August 8, 1990, as a result of drought, the affected area was declared a disaster area eligible for federal assistance. The income you may elect to postpone until 1991 is $9,100 ($35,100 ÷ 135 × 35).

How to make the election. To make the election, attach a statement to your tax return for the year of the sale. The statement must include your name and address and give the following information for each class of livestock for which the election is made:

1) A statement that you are making an election under section 451(e),
2) Evidence of the drought conditions which forced the early sale or exchange of the livestock and the date, if known, on which an area was designated as eligible for assistance by the federal government because of drought conditions,
3) A statement explaining the relationship of the drought area to your early sale or exchange of the livestock,
4) The number of animals sold in each of the 3 preceding years,
5) The number of animals you would have sold in the tax year had you followed your normal business practice in the absence of drought,
6) The total number of animals sold and the number sold because of drought during the tax year, and
7) A computation, as described earlier, of the income to be postponed for each class of livestock.

The statement and the return must be filed by the due date of the return, including extensions. You can file the statement with an amended retu
you file it by this due date. However, once th
election has been made, it may be changed
with the approval of the IRS.

If you have drought sales in more than 1 y
you must make a separate election for each

Rent and Crop Shares

The rent you receive for the use of your fa
is generally rental income, not farm income,
reported on Schedule E. However, if you ma
ally participate in the farming operations on
land, the rent may be considered farm incor
rather than rental income and is reported or
Schedule F.

Pasture income and pasture rental. If yo
pasture someone else's cattle and assume
responsibility for furnishing water, salt, etc.,
fee, the income is from your farming busine
must be entered as *Other* farm income on S
ule F. But if you simply rent your pasture, th
income is reported as rent in Part I of Schec
(Form 1040).

Crop Shares

Rents you receive in crop shares must be in
in income in the year the crop shares are re
to money or the equivalent of money, wheth
report on the cash or the accrual method. If
materially participated in the operation of a
from which you received rent in the form of
shares or livestock, the rental income is sub
self-employment tax and should be reportec
Schedule F. However, if you did not materia
participate in the operation of the farm, repo
income on Form 4835, *Farm Rental Income*
Expenses, and carry the totals to Schedule
(Form 1040). This income is not subject to s
employment tax. See *Landlord Participation*
Farming in Chapter 15.

Crop shares you use to feed livestock.
shares you receive as a landlord and feed t
livestock are considered reduced to money
fed to the livestock. The fair market value o
crop shares must be included in income at t
time. You are entitled to a business expens
deduction for the livestock feed in the same
amount and at the same time you include th
market value of the crop share as rental inc
Even though these two transactions would
each other for purposes of determining adju
gross income on Form 1040, they may be n
sary to determine net earnings from self-employment under the optional method dis
in Chapter 15.

Crop shares you give to others. Crop sh
you receive as a landlord and give to others
considered reduced to money at the time yo
make the gift. You must report the fair mark
value of the crop share as income, even tho
someone else receives payment for the cro
share.

Example. Part of your land was farmed
tenant farmer under a crop share arrangem
The crop was harvested and delivered in 1
your name, to an elevator company. Before
any of the crop, you instructed the elevator
pany to cancel your warehouse receipt for
make out new warehouse receipts in equal
amounts of the crop in the names of your c
Your children sold the crop during 1990 an
and payments for the crop were made dire
them by the elevator company.

In this situation, you are considered to ha
received rental income and then made a gi
income you received. You must include the
market value of the crop in your income for
year you gave the crop to your children.

Crop-share loss. If you are involved in a
or crop-share lease arrangement, any loss
these activities is subject to the limits unde

passive loss rules. See Publication 925, *Passive Activity and At-Risk Rules*, for information on these rules.

Agricultural Program Payments

All government payments, such as those for approved conservation practices, must be included in income, whether you receive them in cash, materials, services, or commodity certificates. However, you may exclude some payments you receive under certain cost-sharing conservation programs, as explained later.

Report the agricultural program payments on the appropriate lines in Part I of Schedule F in the tax year you actually or constructively receive them. The full amounts are reported even if you return a government check for cancellation, refund any of the payments you receive, or the government collects all or part of such payments from you by reducing the amount of some other payment or Commodity Credit loan. However, the amount you refund or return, or that reduces some other payment or loan to you, is deductible on Schedule F in the year of repayment or reduction.

Commodity Credit Loans

Normally, you report income from a crop in the year you sell it. However, if you pledge part or all of your production to secure a Commodity Credit Corporation (CCC) loan, you can elect to report the loan proceeds as income in the year you receive them rather than in the year of sale. You do not need permission from the IRS to adopt this method of reporting CCC loans, even though you may have reported those received in earlier years as taxable income in the year the crop was sold.

Once you report a loan as income in the year received, however, you must report all succeeding loans in the same way, unless you obtain permission from the IRS to change to a different method. See *Change in Accounting Method* in Chapter 3.

To make the election, include on line 7a of Schedule F the amount of the loan as income in the year you receive it. Attach a statement to your return indicating that you are making the election and showing the amount of the loan, the year it was received, the commodity it was for, and the quantity of the commodity.

When you make this choice to report the CCC loan proceeds as income, the amount you report becomes your basis in the commodity. If you later sell the commodity by forfeiting it to the CCC in lieu of repaying the loan or by repaying the loan, redeeming the commodity, and selling it to someone else, you need only report as income at the time of sale the amount of the loan forgiveness or sale proceeds that are greater than your basis in the commodity. If the loan forgiveness or sale proceeds are less than your basis in the commodity, you can report the difference as a loss on Schedule F.

Commodity Credit (PIK) Certificates

Farmers may receive payments under some government programs in the form of commodity credit certificates, sometimes called generic commodity certificates, or ***PIK*** (payment-in-kind) certificates. The recipient of the certificates may sell them, use them to pay price support loans and other debts to the federal government, hold them and redeem them for cash later in the year, or use them to buy commodities from the CCC.

If you receive these commodity credit certificates, or if they are made available as payment under government programs, include the face value of the certificates in income. These payments are taxable in 1990 even if you return them to the USDA for repayment in 1991. Similarly, these payments are taxable in 1990 even if you do not cash, deposit, or redeem the 1990 certificates representing the payments until 1991. The amount you include in income becomes your basis to figure gain or loss on the certificates when you sell them, redeem them, or otherwise dispose of them.

You should receive a 1990 Form 1099–G, *Statement for Recipients of Certain Government Payments*, from the Department of Agriculture for all payments.

Certificates used to pay off CCC loans. If you pledged grain or other commodities to secure a loan from the CCC and also received (or purchased) commodity certificates, you may use these certificates to pay off your loan. As explained earlier, you must include the face value of the certificate you receive under a government program in your income in the same year you receive it.

If you make the election to report the CCC loan as income, you are treated as selling the commodity for the amount of the loan proceeds when the commodity is pledged as collateral for the loan. Report the loan amount on line 7a of Schedule F. When you repay the loan with your certificates, the transaction is treated as a purchase of the commodity in exchange for your certificates. Include on line 7b of Schedule F the amount of the loan you repaid with certificates.

There is no gain or loss when you repay the loan using your commodity credit certificates. In this case, do not include an amount on line 7c of Schedule F as taxable income. However, if the face amount of certificates you use to pay off the CCC loan is less than the amount of the loan, reduce your basis in the commodity (the loan amount) by the amount for which you are no longer liable. There is taxable gain if you later sell the commodity for more than your adjusted (reduced) basis in the commodity.

If you do not elect to include the CCC loan in income when you receive it and use the commodity certificates to repay the loan, recognize income in the year you repay the loan. Include on line 7b of Schedule F the amount of the loan repaid with certificates. Include on line 7c, as taxable income, the amount by which the face amount of the loan exceeds your basis in the certificates used to repay the loan. In this case, your basis in the commodity is zero. Therefore, when you later sell the commodity, you must recognize the full amount received on the sale as taxable gain.

Example 1. George Green is a farmer using the cash receipts and disbursements method of accounting. He files his return on a calendar year basis. In 1990, under a government diversion program, he received PIK certificates (discussed earlier) with a total face value of $5,000 and purchased other PIK certificates at face value for $10,000. In 1990, he also borrowed $16,000 from the CCC, pledging grain to the CCC as security for a nonrecourse loan.

George currently deducted all expenses incurred in producing grain and had a zero basis in the grain that was pledged. He elects to treat the proceeds of the CCC loan as income in the year received. Although under U.S. Department of Agriculture (USDA) regulations the CCC transaction is a loan, his election to include the loan proceeds in income results in the grain being treated, for federal income tax purposes, as sold when it was pledged.

Later in 1990, when the value of the grain securing the nonrecourse loan had fallen to $14,000, George notified the CCC that the loan would be repaid with $14,000 of the PIK certificates. He then reacquired the grain from the CCC for its current value of $14,000. In 1991, he will sell the grain for $16,500.

In light of the above facts, George has income of $5,000 on the receipt of the PIK certificates in 1990 and a basis of $15,000 in the total amount of certificates he holds. He also has income of $16,000 in 1990 from the sale of grain at the time it was pledged. His repayment of the CCC loan is treated as a purchase of the grain in exchange for the certificates. He recognizes no gain or loss on this purchase.

George's basis in the repurchased grain is $14,000 ($16,000, the loan amount, reduced by $2,000, the amount of liability from which he is relieved). His sale of the grain in 1991 will result in a gain of $2,500, the amount realized ($16,500) over his basis in the grain ($14,000).

Example 2. Assume the same facts in Example 1 except that George Green did not make the election to treat the proceeds of the CCC loan as income. Therefore, unlike Example 1, the loan transaction is not considered a sale of the grain when it was pledged. As in Example 1, George has income of $5,000 upon the receipt of the PIK certificates in 1990. When he repaid the loan with the certificates, he has income of $2,000, the excess of the loan ($16,000) over his basis in the certificates used to repay the loan ($14,000). The sale of the grain in 1991 results in a gain of $16,500, the excess of the sale proceeds ($16,500), over his basis in the grain ($0).

Conservation Reserve Payments

Under the Conservation Reserve Program (CRP), the Secretary of Agriculture and an owner or operator of highly erodible cropland may enter into a long-term contract providing for conversion to a less intensive use of that cropland. Under this program, the owner or operator can receive compensation for such conversion in the form of an "annualized rental payment."

The payment may be in the form of cash, commodity certificates, or a combination of cash and certificates. This payment provides compensation for potential income from your land if you used it for production of an agricultural commodity.

The annual CRP payment is a receipt from farm operations that you report in Part I of Schedule F. However, if you do not materially participate in production or management of production of the farm products on your land, see the discussion under *Landlord Participation in Farming* in Chapter 15.

Crop Insurance and Disaster Payments

You must generally include crop insurance proceeds you receive as the result of crop damage in your income for the year you receive them. Crop disaster payments you receive from the federal government, as the result of destruction or damage to crops or the inability to plant crops, because of drought, flood, or any other natural disaster, are treated as crop insurance proceeds.

Election to postpone reporting. If you use the cash method of accounting, you may elect to postpone reporting crop insurance proceeds from the tax year the crops were damaged to the following year. You may make this election if you can show that you would have reported your income from the damaged crops in any tax year following the year the damage occurred. However, if you receive the insurance proceeds in the tax year following the tax year of the destruction or damage, then you include the proceeds in gross income for the year of receipt without having to make the election.

To make the election to postpone reporting crop insurance proceeds, attach a statement to your tax return, or amended return, for the year the damage took place. Merely indicating on your return that insurance proceeds were deferred does not constitute this election. The statement must include your name and address and contain the following information:

1) A statement that you are making an election under section 451(d) of the Internal Revenue Code and section 1.451–6T of the Income Tax Regulations,

2) The specific crop or crops destroyed or damaged,

3) A statement that under your normal business practice you would have included income derived from the destroyed or damaged crops in your gross income for a tax year following the tax year of the destruction or damage,
4) The cause of the destruction or damage and the date or dates it occurred,
5) The total amount of payments you received, itemized for each specific crop, and the date each payment was received, and
6) The name of the payer or payers from whom you received payments.

One election covers all crops from your farm. Your election covers all insurance proceeds from crops representing a single trade or business. If you have more than one farming business, make a separate election for each one. For example, if you operate two separate farms on which you grow different crops, and you keep separate books for each farm, you should make two separate elections if you want to defer reporting insurance proceeds you received for crops grown on each of your farms.

An election is binding unless the District Director for the district where you file your return consents to a change. If you want to change your election, write to your District Director giving your name, address, identification number, the year you made the election, and your reasons for wanting to change it.

Feed Assistance and Payments

Qualified livestock producers may receive feed assistance, reimbursement payments, and other benefits because of a natural disaster under Title I of the Disaster Assistance Act of 1988, and Title II of the Disaster Assistance Act of 1989. These programs include partial reimbursement for expenses to purchase feed and for certain transportation expenses. They also include receipt of feed from the Commodity Credit Corporation, either as a donation or below-market-purchase price.

Title I payments are not proceeds from the sale of livestock, or received for the destruction or damage to crops raised for sale, or for the inability to raise such crops. Therefore, you include these benefits in income.

You must include in income the market value of donated feed or the difference between the market value and the price you paid. You can usually take a current deduction for the same amount as feed expense. However, if you are required to capitalize feed expense, you must also capitalize the value of the donated feed or the amount of the price reduction of feed received under Title I.

Other Payments

Other government program payments must be included in income as explained below.

Dairy Termination Program. If you are receiving payments under the Dairy Termination Program (DTP), continue to report payments received under the allocation you previously determined. That is, as payment received for the sale of your dairy herd and/or as payment received in lieu of milk production income. If you are retired and receiving payments in lieu of milk production, this income is subject to self-employment tax.

Fertilizer and lime. If you get fertilizer or lime under a government program, include the value of the fertilizer or lime (as figured in the government program) in your income. The manner of claiming the offsetting deduction is explained under *Fertilizer and lime* in Chapter 5.

Improvements. If the government payments are based on improvements, such as a pollution control facility, they are still included in income. Your basis in the facility is increased by the amount of these payments included in your income. However, if you have already capitalized the full cost of the facility, do not increase the basis further by these payments, since the costs they represent are already reflected in your basis.

Your basis can be recovered through annual deductions for depreciation or amortization starting on the date the facility is placed in service. Generally, you may elect to amortize the cost of a certified pollution control facility over a period of 60 months. See *Pollution control facilities* under *Amortization* in Chapter 8. Otherwise, you may take depreciation.

Information returns. A program payment intended for more than one person is reported by the U.S. Department of Agriculture to the IRS as having been paid to the person whose identification number is on record for that payment (payee of record). If you, as the payee of record, receive program payments actually belonging to someone else, such as your landlord, the amount belonging to the other person is a nominee distribution. You should file Form 1099–G, *Statement for Recipients of Certain Government Payments*, to let the IRS know the identity of the actual recipients of the payments. You should also furnish this information to the recipients. You may avoid the inconvenience of unnecessary inquiries about the identity of the recipients if you file this form. This form is available at local offices of the IRS.

See Chapter 2 for more information about the preparation of Forms 1099.

Cost-Sharing Exclusion

Part or all of the payments you receive under certain federal or state cost-sharing conservation, reclamation, and restoration programs can be excluded from the income you report on your tax return. However, this exclusion applies only if the payments meet all three of the following tests.

1) You may not exclude any payment for an expense you could deduct in the current tax year. Nor may you exclude a payment that is rent for the use of your property or compensation for your services. You must include the payment in income and take the offsetting deduction, if any. Therefore, if you receive a cost-sharing payment in connection with your farming business, it must be for a capital expenditure for you to exclude it.
2) A payment can be excluded only if the IRS determines that it does not substantially increase your annual income from the property for which it is made. An increase in annual income is substantial if it exceeds the greater of 10% of the average annual income derived from the affected property before receiving the improvement or an amount equal to $2.50 times the number of affected acres.
3) A payment can be excluded from income only if the Secretary of Agriculture certifies that it was made primarily for conserving soil and water resources, protecting or restoring the environment, improving forests, or providing a habitat for wildlife. The following federal programs are certified:

The rural abandoned mine program authorized by the Surface Mining Control and Reclamation Act of 1977.

The water bank program authorized by the Water Bank Act.

The emergency conservation program authorized by title IV of the Agricultural Credit Act of 1978.

The agricultural conservation program authorized by the Soil Conservation and Domestic Allotment Act.

The Great Plains conservation program authorized by section 16 of the Soil Conservation and Domestic Allotment Act, except for payments for practices GP–17 and GP–28.

The forestry incentives program authorized by section 4 of the Cooperative Forestry Assistance Act of 1978.

The experimental rural clean water prog
small watershed program, authorized
Agriculture, Rural Development, and
Agencies Appropriations Acts for fisc
1980 and 1981, for payments made f
approved conservation practices afte
ary 20, 1980, to projects that qualify
watersheds.

Any other small watershed program ad
tered by the Secretary of Agriculture
determined by the Commissioner to
substantially similar to the types of p
for which an exclusion is allowed.

Several state programs have been appro
information about the status of those pro
contact the state offices of the Agricultur
zation and Conservation Service (ASCS),
Soil Conservation Service (SCS).

Income realized. The amount of gross
you will realize upon a payment under th
sharing programs is the value of the imp
reduced by the excludable portion and y
of the cost of improvement. You exclude
amount the greater of:

1) 10% of the average gross receipts f
affected acreage for the 3 tax years
the improvement, or
2) $2.50 times the number of affected

Effects of the exclusion. When you fi
basis in property you acquire or improve
cost-sharing payments you exclude from
subtract the amount of those payments
capital costs. That is, your basis cannot
amounts excluded from income. Moreo
you sell the property, part or all of your
be ordinary income rather than capital
Section 1255 property in Chapter 11.

In addition, you cannot figure depreci
amortization, or depletion deductions fo
of the cost of the property for which yo
cost-sharing payments that you exclude
income.

To the extent the exclusion applies,
so indicate on an attachment to your ta
amended return) for the tax year you re
last payment made by the government
improvement. State the dollar amount
funded by the government payment, th
the improvement, and the amount you
excluding.

Electing out. You may elect *not* to e
part of any payments you receive unde
grams. The election must be made no
the due date, including extensions, for
return. If you elect not to exclude thes
none of the restrictions and rules men
above under *Effects of the exclusion*

Soil and water conservation expen
have expenses for soil and water con
see Chapter 6.

Income from Coope

If you purchase farm supplies through
tive, you may have income from the c
the form of patronage dividends (expl
If you market your farm products thro
erative, you may get patronage divide
unit retain certificate (explained later)
cooperative.

Patronage Dividends

Patronage dividends you receive are
reported as income on line 5a of Sch
the tax year you receive them. This i
amount of money you receive as a p
dend, the stated dollar value of quali
notices of allocation (explained next)
and the fair market value of other pr
receive. However, nonqualified alloc

(explained later) are not included in your income when you receive them. See *Purchases of depreciable and capital assets* and *Personal purchases,* later, for a discussion of amounts not to include in your income.

Qualified written notices of allocation. A qualified written notice of allocation is taxable in the year received at its stated dollar value. To be qualified, you must receive a written notice of your right of redemption at the time you receive your written notice of allocation. It must also be redeemable in cash at any time for a period of at least 90 days after it is issued. It must be paid, as part of a patronage dividend or as part of a payment by a cooperative, in money or qualified check equal to at least 20% of the dividend or payment.

You must also have agreed to report the stated dollar value in income in the year the notice is received. You make the agreement either in writing or by obtaining or retaining membership in the cooperative after it adopted a bylaw providing that membership constitutes agreement. The cooperative must notify you of this bylaw and provide you a copy. You also consent to an allocation if you endorse and cash a qualified check, paid as part of the notice of allocation, on or before the 90th day after the close of the payment period for the tax year of the cooperative.

Nonqualified notices of allocation. All other written notices of allocation are not qualified or included in your income when received. Any nonqualified notice of allocation you receive from the cooperative has a zero basis in your hands. Any amount you receive from the sale, redemption, or other disposition of a nonqualified written notice of allocation is ordinary income reported in Part I of Schedule F for the tax year of disposition to the extent of its stated dollar value. Any amount received in excess of the stated dollar value must be included on your return according to the type of income it represents. For example, if the excess represents interest income, include it as interest on your return for the year of disposition.

Loss on redemption. A loss incurred on the redemption of a qualified written notice of allocation that you received in the ordinary course of your farming business is deductible as an ordinary loss in Part II of Schedule F. The loss is measured by the difference between the stated dollar amount included in your income on receipt and the amount received on redemption.

Purchases of depreciable and capital assets. Do not include in your income dividends you receive that are directly attributable to the purchase of capital assets or depreciable property used in your business that would otherwise be taxable under the preceding rules. You must, however, reduce the basis of these assets by the amounts of the dividends. If the dividends are more than your unrecovered cost, include the excess in income as ordinary income on Schedule F for the tax year you receive them. Include all these dividends on line 5a of Schedule F, but include only the taxable part on line 5b.

If the dividends are attributable to the marketing or purchasing of capital assets or depreciable property used in your business and you did not own the property at any time during the year you received the dividends, you must generally include the dividends in income unless either of the following exceptions applies:

1) The dividends will be treated as a gain from the sale or exchange of a capital asset held for more than one year if the dividends relate to a capital asset held by you for more than one year and a loss was or would have been deductible, or
2) The dividends will not be reported as income (ordinary income or capital gain) if they relate to a capital asset for which a loss was not or would not have been deductible.

If you receive a dividend attributable to the marketing of a capital asset or depreciable property used in your business in the same year the asset was marketed, treat the dividend as an additional amount received on the sale or other disposition of the asset.

If you cannot determine the item to which the dividend is attributed, include the dividend amount in income as ordinary income.

Personal purchases. Dividends you receive that are directly attributable to the purchase of personal, family, or living items, such as supplies, equipment, or services that were not used in your business, are not included in your income. This rule also applies to amounts you receive from the sale, redemption, or other disposition of a nonqualified written notice of allocation resulting from these purchases. If the dividend or nonqualified allocation cannot be traced to these purchases, it is treated in the regular manner already described. Include these dividends in the amounts you show on both lines 5a and 5b of Schedule F.

Per-Unit Retain Certificates

A per-unit retain certificate is any written notice that discloses to the recipient the stated dollar amount of a per-unit retain allocation issued to the patron by the cooperative. A per-unit retain allocation is an amount paid to patrons for products marketed for them that is fixed without regard to the net earnings of the cooperative. These allocations can be paid in money or other property or in qualified certificates.

Per-unit retain certificates issued by a cooperative generally receive the same tax treatment as patronage dividends already discussed.

Qualified certificates. Qualified per-unit retain certificates are those issued to patrons who have consented in writing, or in effect have their consent by obtaining or retaining membership in a cooperative whose bylaws or charter state that membership constitutes consent, to take into account the stated dollar amount of these certificates in the year of receipt. Thus, if you receive qualified per-unit retain certificates, include the stated dollar amount of these certificates in your income in Part I of Schedule F for the tax year you receive them.

Nonqualified certificates. Nonqualified per-unit retain certificates are all other per-unit retain certificates. If you receive nonqualified per-unit retain certificates, you include nothing in your income for the tax year you receive them. However, any amount you receive from the redemption, sale, or other disposition of a nonqualified per-unit retain certificate, to the extent the stated dollar amount exceeds its basis, is ordinary income reported in Part I of Schedule F for the tax year of disposition.

Cancellation of Debts

If a debt you owe is canceled or forgiven other than as a gift to you, you must generally include the canceled amount in your gross income for tax purposes. A debt includes any indebtedness for which you are liable or which attaches to property you hold.

If you owe a debt to the seller for the purchase of property and the seller reduces the amount you owe, you do not have income from the reduction even though you are not bankrupt or insolvent. The debt reduction is treated as a purchase price adjustment and reduces your basis in the property. However, if you receive a discount for prepaying all or a part of a debt held by a third party, you realize income to the extent of the cancellation.

Student loan exclusion. There is an exception to the general rule for certain student loans that are canceled. A student loan is a loan to assist an individual in attending an educational institution.

You do not include in income the amount of your student loan that is canceled when the cancellation is pursuant to a student loan provision under which all or part of the indebtedness would be discharged if the loan recipient worked for a certain period of time in certain professions for one of a broad class of employers.

To qualify, the loan must have been made by:

1) The government—federal, state, or local or an instrumentality, agency, or subdivision thereof,
2) A tax-exempt public benefit corporation that has assumed control of a state, county, or municipal hospital, and whose employees are considered public employees under state law, or
3) An educational institution under an agreement with an entity described in (1) or (2) that provided the funds to the institution to make the loan.

Canceled Debt Exclusion

There is a relief provision from the general rule requiring inclusion of a canceled debt in gross income. Generally, the amount excluded from gross income is applied to reduce certain tax benefits (the tax attributes). The relief provisions apply to canceled debt in the following situations:

1) The cancellation takes place in a bankruptcy case under title 11 of the United States Code.
2) The cancellation takes place when you are insolvent and the amount excluded is not more than the amount by which you are insolvent.
3) The cancellation is a qualified farm debt discharged by an unrelated lender.

If a debt cancellation is excluded from income because it takes place in a title 11 bankruptcy case, items (2) and (3) above do not apply. If it takes place when you are insolvent, item (3) does not apply to the extent you are insolvent.

Tax benefit reduction. There is a specific order for reducing tax benefits. The rules for qualified farm debt are different from the rules for bankruptcy and insolvency. However, in all three cases, you may apply any portion of the canceled amount to reduce the basis of depreciable property before reducing other tax benefits.

Election to Reduce Basis First

You may choose to apply any portion of your canceled debt to reduce the basis of your depreciable property before reducing other tax benefits. The amount you apply cannot exceed the total adjusted bases of all depreciable property you held at the beginning of the tax year following the tax year of your debt cancellation.

Depreciable property. Depreciable property, for this purpose, means any property subject to depreciation, but only if a reduction of basis will reduce the amount of depreciation or amortization otherwise allowable for the period immediately following the basis reduction.

Debt included in income. If an amount of canceled debt is not excludable from income under the three provisions listed above, it must be included in gross income in the year the obligation is discharged or canceled. However, income is not realized from debt cancellation when payment of the debt would give rise to a deduction.

Example. You use the cash method of accounting for your business. You obtain business accounting services on credit. Later, you have trouble paying your business debts. You are not bankrupt or insolvent, but your accountant forgives part of the amount you owe for the accounting services. You do not include the amount of the debt cancellation in income because payment for the services would be deductible as a business expense under the cash method of accounting.

However, if in the above example you use the accrual method of accounting, you include the cancellation of this debt in income because, under the accrual method, the expense is deductible when the liability is incurred, not when the debt is paid.

Bankruptcy

A bankruptcy case is a case under title 11 of the United States Code, provided you are under the jurisdiction of the court and the discharge of the debt is granted by the court or is pursuant to a plan approved by the court.

No debt canceled in a bankruptcy case is included in your gross income in the year it is canceled. Instead, the amount canceled must be used to reduce your tax benefits, explained later.

If you are an individual filing for bankruptcy under chapter 7 (liquidation) or chapter 11 (reorganization) of title 11 of the United States Code, you must make the required reduction of tax benefits to those benefits acquired by the bankruptcy estate, a separate taxable entity resulting from the filing of the case. The trustee of the bankruptcy estate must also choose whether to first reduce the basis of depreciable property before reducing other tax benefits.

Insolvency

You are insolvent when, and to the extent, your liabilities exceed the fair market value of your assets. Your liabilities and the fair market value of your assets must be determined immediately before the discharge of your debts.

When you are insolvent, exclude from your gross income the amount of your canceled debts up to the amount by which you are insolvent. If the amount of your canceled debts exceeds the amount by which you are insolvent, you can then apply the rules for qualified farm debt to the excess, provided you qualify for this exclusion. Otherwise, you include the excess in gross income. Use the amount excluded for insolvency to reduce tax benefits under the insolvency rules before applying the rules for qualified farm debt.

Example 1. You had $10,000 debt canceled outside of bankruptcy. Immediately before the cancellation, your liabilities totaled $80,000, and your assets totaled $75,000. Since your liabilities exceeded your assets, you were insolvent to the extent of $5,000 ($80,000 − $75,000).

Example 2. You transferred property to a bank to satisfy a debt for which you are personally liable and which is secured by the property. You owe the bank $12,000. The property has a fair market value of $10,000, and your adjusted basis in the property is $8,000. Assuming this is your only asset, you are insolvent for the difference between the amount of your debt ($12,000) and the fair market value of the transferred property ($10,000). You must recognize a gain of $2,000 for the difference between the fair market value and your adjusted basis in the property.

Qualified Farm Debt Exclusion

You can exclude from income the cancellation or discharge of qualified farm debt to the extent you are solvent. The debt must be discharged by a qualified person, explained later. The amount excluded must be used to reduce certain tax benefits, explained later. These rules are not the same as the rules for bankruptcy or insolvency.

Qualified farm debt. Your debt is qualified farm debt if:

1) You incurred it directly in operating a farming business, and
2) At least 50% of your total gross receipts for the 3 tax years preceding the year of debt cancellation were from your farming business.

To see if you meet this requirement, divide your total gross receipts from farming for the 3–year period by your total gross receipts from all sources, including farming, for that period. See Chapter 2 for information about gross farm income and total gross income.

Qualified person. The person who cancels or forgives your qualified farm debt is a qualified person if that person is actively and regularly engaged in the business of lending money and is not:

1) A person related to you,
2) A person from whom you acquired the property (or a person related to this person), or
3) A person who receives a fee from your investment in the property (or a person related to this person).

A qualified person includes any federal, state, or local government (or any agency or instrumentality of those governments). Therefore, these rules apply to debts discharged by the U.S. Department of Agriculture.

For the definition of a related person, see *Related persons* under *At-Risk Amounts* in Publication 925, *Passive Activity and At-Risk Rules.*

Reduction of Tax Benefits in Bankruptcy and Insolvency

The amount of debt excluded from income, and not used to reduce the basis of depreciable property in a bankruptcy case or during insolvency, must be used to reduce certain tax benefits. By reducing these benefits, tax on the canceled debt is postponed in part instead of entirely forgiven. This prevents an excessive tax benefit from the debt cancellation.

Tax benefits. You must reduce the tax benefits in the following order:

1) ***Net operating loss.*** Reduce any net operating loss for the tax year the debt cancellation takes place, and any net operating loss carryover, to that tax year. This reduction is on a dollar for dollar basis.
2) ***General business credit carryovers.*** Reduce any carryovers to or from the tax year of the debt cancellation. Reduce these carryovers at the rate of 33⅓ cents for each dollar of debt cancellation exclusion.
3) ***Capital losses.*** Reduce any net capital loss for the tax year of the debt cancellation, and any capital loss carryover, to that year. This reduction is on a dollar for dollar basis.
4) ***Basis.*** For each dollar of debt cancellation, reduce the basis of your property by one dollar. This reduction applies to the basis of both depreciable and nondepreciable property. The reduction in basis cannot be more than the total basis of property you hold immediately after the debt cancellation, minus your total liabilities immediately after the cancellation.
5) ***Foreign and possession tax credits.*** Reduce any carryover to or from the tax year of the debt cancellation. Reduce these credits at the rate of 33⅓ cents for each dollar of debt cancellation.

Reduction of Tax Benefits for Qualified Farm Debt

If your canceled debt is qualified farm debt, the amount you exclude from income cannot exceed the sum of your adjusted tax benefits and the total adjusted bases of your qualified property, defined later. If the income you realize from the discharged debt exceeds this limit, include the excess in your gross income.

Adjusted tax benefits. Adjusted tax benefits means the sum of the following:

1) Any net operating loss (NOL) for the year of the discharge and any NOL carryovers to that year,
2) Any general business credit carryover to or from the year of discharge, multiplied by 3,
3) Any net capital loss for the year of the discharge and any capital loss carryovers t that year, and
4) Any foreign tax credit carryovers to or from the year of the discharge, multiplied by 3.

The reason you multiply your credits by 3 is to make them more comparable with your deduct benefits.

Example. You had a $300 general busines credit carryover to the year of your debt cance tion. You applied $300 of your debt cancellatio against this credit under the insolvency rules which reduced the credit to $100. You now mu ply this amount by 3, resulting in an adjusted ta general business credit of $300 which you red on a dollar for dollar basis.

Order of reduction. After reducing adjusted t benefits (1), (2), and (3), in that order, by the excluded amount, but before reducing adjusted tax benefit (4), apply any remaining excluded amount to reduce your qualified property basis.

Qualified property. Qualified property is any property you use or hold for use in your busine or for the production of income. You must redu the basis of this qualifying property in the follo order:

1) Depreciable property,
2) Land you use in your farming business, an
3) Other qualified property.

How to Make Tax Benefit Reductio

In all cases, make the required reductions in ta benefits after figuring the tax for the tax year o the debt cancellation. In reducing net operatin losses and capital losses, first reduce the loss the tax year of the debt cancellation. Then red any loss carryovers to that year in the order of tax years from which the carryovers arose, sta with the earliest year. Make your reductions of credit carryovers in the order in which they are taken into account for the tax year of the debt cancellation.

When to make basis reductions. The reduc in basis is made at the beginning of the tax ye following the tax year of the debt cancellation applies to property held by you at that time.

Recapture of basis reductions. If the basis property is reduced under these provisions, a later sold or otherwise disposed of at a gain, part of the gain attributable to this basis reduc is taxable as ordinary income. Figure the ordi income part by treating the amount of this ba reduction as a depreciation deduction. Any pr erty having its basis reduced under these pro sions that is not section 1245 or section 1250 property is treated as section 1245 property. section 1250 property make the determinatio straight line depreciation as though there wer basis reduction for debt cancellation. Section 1245 and 1250 and the recapture of gain as nary income are explained in Chapter 11.

When to File

You must file Form 982, *Reduction of Tax Att utes Due to Discharge of Indebtedness,* with income tax return for the tax year in which th cancellation of debt occurred. If you fail to fil form with your original return, you must file it an amended return or claim for credit or refu

Also use this form to elect to reduce depre ble property basis before reducing other tax fits. However, if you fail to make this election your original return, you must establish reaso cause with IRS before you can make the ele on an amended return or claim for credit. Th election may be revoked only with IRS conse

More information. For more information o cancellation, see Publication 908, *Bankrupto Other Debt Cancellation.*

ther Income

is section discusses some other types of come you might have.

egal federal irrigation subsidies. The federal overnment operating through the Bureau of Rec- mation has made irrigation water available for ricultural purposes from certain reclamation and igation projects referred to in the Reclamation eform Act of 1982. For water delivered after 987, the excess of the amount required to be id over the amount actually paid is an illegal bsidy.

For example, if the amount required to be paid full cost and you paid an amount less than full st, the excess of full cost over the amount you id is an illegal subsidy. You must include the mount of this illegal subsidy in your gross come. Report this amount on line 10 of Sched- e F. You cannot take a deduction for the amount u are required to include in your income. For ore information, contact your local Bureau of eclamation office.

imber sales. Timber sales, including sales of gs, firewood, lumber, and pulpwood, are scussed in Chapter 10.

oil and other natural deposits. If you remove nd sell topsoil, loam, fill dirt, sand, gravel, or ther natural deposits from your property, the pro- eeds are ordinary income. A reasonable allow- nce for depletion of the natural deposit sold may e claimed as a deduction. See *Depletion* in hapter 8.

If you enter into a legal relationship granting omeone else the right to excavate and remove hese natural deposits from your property, deter- nine whether the transaction is a sale or some ther kind of transaction (for example, a lease). This is because your income from the deposits is apital gain if the transaction is a sale. Otherwise, he income is ordinary income, but is subject to an llowance for depletion.

The transaction is a sale if you retain no eco- omic interest in the deposit. You are considered o retain an economic interest if, under the terms f the legal relationship, you must depend on the ncome derived from extraction of the deposit for a eturn of your capital investment in the deposit. On he other hand, if you are to receive a specified um or an amount fixed without regard to how much is produced and sold from the deposit, your ransaction is a sale. You cannot take deductions or depletion, but your income is capital gain. See Chapter 10 for the tax treatment of capital gains.

Sod. Proceeds from the sale of sod are reported on Schedule F. A deduction for cost depletion is allowed, but only with respect to the amount of topsoil removed with the sod.

Fuel tax credits and refunds. Include as income any credit or refund of federal excise tax. But the excise tax you paid as part of the fuel cost must have been claimed as an expense deduction that reduced your income tax. See Chapter 17 for more information.

Refunds and reimbursements. Reimbursements, refunds, and recoveries of other items for which you took a deduction in an earlier year should be included in your income for the tax year you receive them. However, if any part of the earlier deduction did not serve to decrease your income tax, you do not have to include that part of the reimbursement, refund, or recovery in your income.

Example. A tenant farmer purchased fertilizer for $1,000 in April 1989. He deducted all of the $1,000 on his 1989 Schedule F. The full amount of the deduction served to lower his tax. Then, in February 1990, the landowner reimbursed him for $500 of the cost of the fertilizer. The tenant farmer must include all of the $500 in his income for 1990, because all of the 1989 deduction caused a decrease in his tax in the earlier year.

Recapture of certain depreciation. If you took a section 179 deduction for property used in your farming business, and at any time you do not use the property predominantly in your business, you must recapture the benefit you received from the deduction by including part of the deduction in your income.

Similarly, if your percentage business use of listed property (see Chapter 8) falls to 50% or less in any tax year, you must include in your income any excess depreciation you took on the property.

Both these amounts are farm income. Use Part V of Form 4797 to figure how much to include in your income.

Easements and rights-of-way. Income you receive for granting easements or rights-of-way on your farm or ranch, for flooding land, for laying pipelines, and for constructing electric and telephone lines, etc., may result in income, or in a reduction of the basis of all or part of your farmland, or both.

Example. You sold a right-of-way for a gas pipeline through your property for $1,000. Only a specific part of your farmland was affected. You reserved the right to continue farming the surface land after the pipe was laid. If the $1,000 received for the right-of-way is less than the basis properly allocated to the part of your land affected by the right-of-way, then the basis is reduced by $1,000. If the amount received is more than the basis of the affected part of your land, the excess is gain from the sale of section 1231 property. See Chapter 11. If, instead of selling a right-of-way, you sold part of your land, you would have a gain or loss from the sale of section 1231 property.

If during construction of the line, growing crops were damaged and you later received a settlement of $250 for this damage, the $250 you received for the destroyed crops is income. Gains and losses are discussed in Chapters 10 and 11.

Property sold, destroyed, stolen, or condemned. If property you own is sold or exchanged, stolen, destroyed by fire, flood, or other casualty, or condemned by a public authority, you will usually have a gain or loss. If the gain is taxable or the loss deductible, it may be ordinary gain or loss or capital gain or loss. In some situations, the tax on your gain may be postponed to a later year. See Chapters 11 and 13.

Machine work (custom hire). Pay you receive for work performed off the farm by you or your hired help, for contract work or custom work done for others, or for the use of your property or machines is income to you, whether or not income tax was withheld at the source. This rule applies whether you receive the pay in cash, services, or merchandise.

Barter income. If you do work for someone and are paid in farm products, property, or in work done for you, you must report the fair market value of what you receive as income. The same rule applies if you trade farm products for other farm products, property, or someone else's labor. This is called barter income. For example, if you help a neighbor build a barn and receive a cow for your work, you must report the fair market value of the cow as ordinary income. Your basis for property you receive in a barter transaction is usually the fair market value that you include in income. If you pay someone with property, see the discussion on labor expense in Chapter 5.

Prizes. Prizes won on farm livestock or products at contests, exhibitions, fairs, etc., are income. If you receive the prize in cash, include the full amount. If you receive the prize in produce or other property, include the fair market value of the property received.

See Publication 525 for more information about prizes.

Commodity futures. Gain from commodity futures transactions may be treated as ordinary income or capital gain, depending on the nature of the transaction. See *Commodity futures contracts* in Chapter 5.

Options. Options are treated under the same tax rules that apply to section 1256 contracts and hedging transactions. Like commodity futures, options may be treated as ordinary income or capital gain, depending on the nature of the transactions. For more information on how to treat such transactions, see Publication 550, *Investment Income and Expenses.*

Below-market loans. If you make a loan that is a below-market loan, you may have to report income from the loan in addition to the stated interest you receive from the borrower. A below-market loan is a loan on which no interest is charged or on which interest is charged at a rate below the applicable federal rate.

This provision applies to demand loans outstanding after June 6, 1984, and to other loans made after that date.

See Publication 545, *Interest Expense,* for more information about these loans.

Nontaxable Income

The following list gives a few types of nontaxable income you may have. Publication 525 discusses nontaxable income in greater detail.

An increase in the value of livestock or a standing crop, if your records are kept on the cash method.

An increase in the value of farm assets, if no sale or exchange has taken place.

The value of a dwelling furnished a tenant farmer by the landowner under the usual tenant-farmer arrangement is not taxable income to the tenant.

5. Farm Business Expenses

Important Change for 1990

Standard mileage rate. The standard mileage rate for 1990 is 26 cents a mile for all business miles. You are not subject to the 15,000 mile annual limit that applied in earlier years.

Deductible Expenses

The ordinary and necessary costs of operating a farm for profit are deductible business expenses. Part II on page 1 of Schedule F lists some of the usual expenses found in farming operations. Many of these expenses and others not listed on Schedule F are discussed in this chapter.

Accounting method. Farm business expenses are not deductible under the accrual method of accounting until economic performance occurs. Economic performance generally occurs as the property or services are provided to you, whether or not you paid the expenses. See Publication 538, *Accounting Periods and Methods,* for more information about economic performance.

The uniform capitalization rules require the capitalization of certain expenses. These rules generally apply to expenses connected with property with a preproductive period of more than 2 years, or property produced by a corporation, partnership, or tax shelter required to use the accrual method of accounting. See *Uniform Capitalization Rules* in Chapter 7.

Reimbursed expenses. Reimbursed expenses must be shown on your return as either a reduction in the expense item or as income, depending on when you receive the reimbursement. See *Refunds and reimbursements* in Chapter 4.

Loss of inventory. A casualty or theft loss of inventory, including items you hold for sale to customers, is automatically claimed through the increase in the cost of goods sold by properly reporting your opening and closing inventories. If you take the loss automatically through the increase in the cost of goods sold, any insurance or other reimbursement you receive for the loss must be included in gross income.

Contested liabilities. If you use the cash method and contest an asserted liability for any of your farm business expenses, you can claim the deduction only in the year the liability is paid. If you are an accrual method taxpayer, however, you can deduct the expense either in the year you pay the contested liability (or transfer money or other property in satisfaction of it), or in the year the contest is finally settled. For more information, see Publication 538.

Prepaid Farm Supplies

Your deduction for prepaid farm supplies may be limited if you use the cash method of accounting to report your income and expenses. This limit will not apply to you, however, if you come under the *exceptions* described later.

Prepaid farm supplies expenses. If this deduction limit applies to you, your prepaid farm supplies expenses are your:

Expenses for feed, seed, fertilizer, and similar farm supplies that will not be used or consumed until a later tax year,

Cost of poultry (including egg-laying hens and baby chicks) bought for use (or both use and sale) in your farming business; you must capitalize the poultry cost and deduct it ratably (for example, on a monthly basis) over the lesser of 12 months or the useful life of the poultry, and

Cost of poultry bought for resale, which you cannot deduct until the year the poultry is sold or otherwise disposed of.

Limitation on deduction. You are allowed a deduction in the tax year of payment for prepaid farm supplies expenses that do not exceed 50% of your other deductible farm expenses. The deduction for any excess prepaid farm supplies expenses is allowed only for the tax year those supplies are actually used or consumed.

Deductible farm expenses. Deductible farm expenses are any amounts allowable as deductions on Schedule F, Form 1040, including depreciation or amortization, but not including your prepaid farm supplies expenses.

Example. During 1990, you purchased fertilizer ($4,000), feed ($1,000), and seed ($500) to be used for your farm in 1991. Your total prepaid farm supplies expenses for 1990 are $5,500. Your other deductible farm expenses totaled $10,000 for 1990. Therefore, your deduction for prepaid farm supplies expenses is limited to $5,000 (50% of $10,000) for 1990. The excess prepaid farm supplies expenses of $500 ($5,500 − $5,000) are deductible in the tax year those supplies are used or consumed.

Exceptions. This limitation on the deduction of excess prepaid farm supplies expenses does not apply to you if you are a farm-related taxpayer (defined next) and either:

1) Your prepaid farm supplies expenses are more than 50% of your other deductible farm expenses because of a change in business operations directly attributable to extraordinary circumstances, or
2) Your total prepaid farm supplies expenses for the preceding 3 tax years are less than 50% of your total other deductible farm expenses for the 3 preceding tax years.

You are a farm-related taxpayer if any of the following applies:

1) Your main home is on a farm.
2) Your principal business is farming.
3) A member of your family meets (1) or (2) above.

Prepaid farm supplies expenses do not include any amount paid for farm supplies that are on hand at the end of the tax year and that would have been consumed, but were not because of fire, storm, flood, other casualty, disease, or drought.

Whether or not these rules for excess prepaid farm supplies apply to you, your expenses for livestock feed may be subject to the rules for advance payment of livestock feed discussed next.

Livestock Feed

If you report your income under the cash method, amounts paid for feed to be consumed by your livestock in the year of payment are deductible in the year paid. However, if you make advance payments for feed to be consumed by your livestock in a later tax year, the expense is deductible in the year the feed is consumed, and not the year payment is made, unless you meet the tests discussed next.

Advance payments for feed. If you meet ***all*** of the following tests, you may deduct, in the year of payment, amounts paid for feed to be consumed by your livestock in a later tax year. This rule does not apply to the purchase of commodity futures contracts.

1) The expense must be a payment for the purchase of feed rather than just a deposit. Whether an expense is a deposit or a payment depends on the facts and circumstances in each case. The expense will be considered a payment if you can show that it is made pursuant to a binding commitment to accept delivery of a specific quantity of feed at a fixed price and you are not entitled, under contract provision or business custom, to a refund or repurchase.

   Some factors that show an expense to be a deposit rather than a payment are:

   - The absence of specific quantity terms,
   - The right to a refund of any unapplied payment credit at the end of the contract,
   - The treatment of the expense as a deposit by the seller, and
   - The right to substitute other goods or products for the products specified in the contract.

   A provision permitting substitution of ingredients to vary the particular feed mix to meet current diet requirements of the livestock for which the feed was purchased will not indicate a deposit. Further, adjustment to the contract price to reflect market value at the date of delivery is not, by itself, proof of a deposit.

2) The prepayment must be made for a business purpose and not merely for tax avoidance.

   You should have a reasonable expectation
   receiving some business benefit as a resu
   the prepayment. Examples of business be
   fits include, but are not limited to: fixing ma
   mum prices and securing an assured feed
   supply or securing preferential treatment in
   anticipation of feed shortage. Whether the
   prepayment was a condition imposed by th
   seller and whether such condition was me
   ingful will also be considered in determinin
   whether there was a business purpose for
   prepayment.

3) The deduction of these costs must not res
   in a material distortion of your income. Ev
   you meet the first two tests, this does not
   automatically mean that the expense will b
   deductible in the year paid. A deferral of th
   deduction may be necessary to clearly ref
   your income. Some factors to be consider
   in determining whether the deduction resu
   in a material distortion of income include, b
   are not limited to, your customary busines
   practice in conducting your livestock oper
   tions, the amount of expense in relation to
   past purchases, the time of year the expe
   was made, and the amount of expense in
   relation to your income for the year.

If you fail to meet these three tests, the amou
paid for feed to be consumed by your livestoc
a later tax year will not be deductible in the ye
paid. The deduction will be allowed in the tax
years your livestock consume the feed.

Labor Hired

You can deduct reasonable wages paid for re
farm labor, piecework, contract labor, and othe
forms of labor hired to perform your farming o
ations. Wages may be paid in cash or other pr
erty, such as inventoriable items, capital asset
assets used in your business. The actual cost
boarding hired farm labor is a deductible labor
cost. Other costs you incur for hired farm labo
that are deductible include health insurance a
workers' compensation insurance.

If you are required to withhold social securit
and income tax from your employees' cash
wages, the full amount of wages before withh
ing is deductible. The social security tax you n
pay on wages to your employees is deductible
a farm business expense on Schedule F. See
Taxes later in this chapter.

Deductible pay. The kinds of pay you can
deduct may include the fair market value of p
erty transferred to your employees, and wage
paid to members of your family, as discussed

Property for services. If you transfer pro
to one of your employees in payment for serv
the fair market value of the property on the da
transfer is deductible as compensation paid.
deductible amount is received in exchange fo
property, and gain or loss is recognized on th
exchange to the extent of the difference betw
the fair market value of the property and its
adjusted basis on the date of exchange. The
or loss has the same character the exchange
property had in your hands. See *If you trade*
property for unlike property in Chapter 11.

Dependent employee. Reasonable wage
other compensation paid to your children for
farm work are deductible if there is a ***true***
employer-employee relationship. These w
are included in the child's income and may re
in the child having to file an income tax retur
These wages may also be subject to social s
ity taxes if your child is age 18 or older. See
ily members under *Social Security Taxes* in
Chapter 16. The fact that your child spends
money to buy clothes or other necessities yo
mally furnish does not prevent you from ded
your child's wages as a farm expense.

Spouse employee. You may deduct wages d to your spouse if a ***true employer-employee*** ***lationship*** exists between you and your spouse. ges paid to your spouse are subject to social curity taxes. See *Family members* under *Social curity Taxes* in Chapter 16.

ndeductible pay. The kinds of pay you nnot deduct include wages paid for household rk, any construction work, and maintenance of ur personal residence, as discussed next.

Household workers. Do not deduct amounts id to persons engaged in household work, cept to the extent their services are used in arding or otherwise caring for farm laborers.

Construction labor. Wages paid to hired help the construction of new buildings or other ms, the cost of which must be capitalized, may t be deducted. These wages are part of the st of the building or other improvement.

Maintaining residence. If your farm employee ends part of the time maintaining or repairing ur personal residence, the wages and social curity tax you pay for that work are nondeductle personal expenses. For example, assume you ve a farm employee for the entire tax year and at 5% of his or her time is spent maintaining ur personal residence and the balance of his or r time is devoted to work on your farm. Five perent of the wages and social security tax you pay not deductible.

obs credit. The deduction for wages must be duced by the dollar amount of the targeted jobs redit allowable for the tax year. Get Form 5884, *obs Credit,* for more information.

ersonal and Business Expenses

ome of the expenses you pay during the tax year ay be partly personal and partly business. These ay include amounts paid for gasoline, oil and el, water, rent, electricity, telephone, automobile pkeep, repairs, insurance, interest, and taxes.

llocation. An allocation of these mixed xpenses must be made because the personal art of them is not deductible as a business xpense.

Example. Your total expense for electricity during the tax year was $1,500. It was used onethird for personal purposes and two-thirds for arming purposes. Under these circumstances, you may deduct two-thirds of your electricity expense ($1,000) as a farm business expense.

Reasonable allocation. It is not always easy o determine the part of a mixed expense that should be allocated to business and the part that should be allocated to nonbusiness activities. No rule can be prescribed for all cases, but the allocation must be reasonable. What is reasonable depends on the circumstances in each case.

Telephone expense. You cannot deduct the cost of basic local telephone service (including taxes) for the first telephone line you have in your home. You may deduct the cost of additional telephone service you have in your home for your farming business.

Repairs and Maintenance

You can deduct most expenses for the repair and maintenance of your farm property. However, repairs to depreciable property that substantially prolong the life of the property or increase its value or adapt it to a different use are capital expenses. If you repair the barn roof, the cost is deductible. But if you replace the roof, it is a capital expense. Common items of repair and maintenance are repainting, the replacing of shingles and supports on farm buildings, and minor overhauls of cars, tractors, and other farm machinery. Major overhauls, however, are to be capitalized.

Interest

You can deduct as a farm business expense the interest you pay on farm mortgages and other obligations incurred to carry on farming and ranching.

If you are on the cash method, the interest must be paid during the year to be deductible. Interest is not considered paid, and so cannot be deducted, if payment was made with funds you got from the original lender through another loan, advance, or other arrangement similar to a loan. You may, however, deduct the interest when you start making payments on the new loan.

If you are on the accrual method, deduct the interest as it accrues.

Allocation of interest. If the proceeds of a loan are applied to more than one use, (for example, personal and business), you must allocate the interest on that loan to each use. See *Allocation of Interest* in Publication 545, *Interest Expense,* for more information.

Prepaid interest. Interest you pay in advance is generally not deductible when paid. Interest you pay in advance that is allocable to periods after the close of the year in which you pay it is deductible over the period of the loan. See Chapter 6, *Interest,* in Publication 535, *Business Expenses,* for more information.

Loan expenses. Loan expenses, such as legal fees, commissions, and other expenses paid in obtaining a farm loan, must be prorated and deducted over the term (life) of the loan.

Breeding Fees

Breeding fees you pay are deductible as a farm business expense. However, if you are a taxpayer required to use the accrual method of accounting, breeding fees must be capitalized and allocated to the cost basis of the calf, foal, etc.

Fertilizer and Lime

The cost of fertilizer, lime, and other materials that are applied to farmland to enrich, neutralize, or condition it, and the cost of applying them, can be deducted as an expense in the year these costs are paid or incurred. Farmland is land used for producing crops, fruits, or other agricultural products or for sustaining livestock. If the benefits of the fertilizer, lime, or other materials last substantially more than a year, you may choose to deduct the expenses in the year paid or incurred, or you may capitalize them and deduct a part for each year the benefits last. However, see *Prepaid Farm Supplies,* earlier, for a rule that may limit your deduction for these materials.

If you choose to deduct these expenses in the year paid or incurred, the choice for that year may be changed only with the consent of the IRS. If you choose to capitalize, the part of the cost deducted need not be the same each year if the benefits are clearly greater in the early years. Government payments you receive for lime or fertilizer must be included in income. See *Fertilizer and lime* in Chapter 4.

Fuels and Oil

The cost of fuels and oil used in your farming business is a deductible farm business expense.

Taxes

You can deduct as a farm business expense the real estate and personal property taxes on farm business assets, such as farm equipment, animals, farmland, and farm buildings. Both the social security tax you must pay to match what you were required to withhold from the wages of farm employees and any federal unemployment tax you must pay are deductible in the year you pay them.

Since taxes on the part of your farm you use as your residence, and its furnishings, are nonbusiness taxes, it is necessary to prorate the taxes between the farm assets and the nonbusiness assets. This can be done on the basis of the assessed valuations. If the assessed valuations are not shown on your tax statement, they can usually be obtained from the tax assessor.

Car licenses. If you use your car for both farm business and nonbusiness purposes, you must prorate the cost of your license tags. The part of the cost applying to nonbusiness use is not deductible as a farm business expense.

State or local general sales taxes. State or local general sales taxes on nondepreciable farm business expense items need not be shown separately, but may be included as part of the cost of the related item. State or local general sales taxes imposed on your purchase of capital assets for use in your farming business are capitalized as part of the cost of the related item and depreciated. If state or local general sales taxes on your purchase of farm business capital assets were imposed on the seller and passed on to you, treat them as a part of the cost of the capital assets.

State and federal income taxes. State and federal income taxes are not deductible as farm business expenses. State income tax is deductible as an itemized deduction if you itemize your deductions. Federal income tax is not deductible.

A state tax on gross income (as distinguished from net income) directly attributable to the business of farming carried on by an individual or a partnership is deductible as a business expense.

Federal use tax. Federal use tax on highway motor vehicles paid on a truck or truck-tractor used in your farming business is a deductible expense. Detailed information about this tax may be found in Publication 349, *Federal Highway Use Tax on Heavy Vehicles.*

Self-employment tax deduction. Beginning in 1990, you can deduct one-half of your self-employment tax in figuring your adjusted gross income on Form 1040. See Chapter 15.

Insurance

Premiums on fire, storm, crop, theft, liability, and other insurance on farm business items or assets are deductible on Schedule F as a business expense. If you carry health and accident insurance on your employees, those premiums are also deductible on Schedule F. Payments for worker's compensation insurance and state unemployment insurance are deductible.

Family health insurance. You may deduct, as an adjustment to income on Form 1040, 25% of the amount paid on your behalf for health insurance for you and your family. The deduction applies to amounts paid and coverage provided for the period January 1, 1990, through September 30, 1990. See the worksheet in the Form instructions on how to compute this deduction. Include the remaining part of this insurance payment in your medical expenses on Schedule A, Form 1040, if you itemize your deductions.

However, when you are also an employee of another person, you may not deduct the medical insurance costs paid if you are eligible to participate in a subsidized plan maintained by your employer. This is true even if it is your spouse who is employed, and you would be eligible to participate in your spouse's employer's plan.

Advance premiums. If you pay insurance premiums in advance, you may deduct each year only the part of the premium that applies to that tax year. You may deduct the balance in each later year to which it applies. This is true whether you report on the cash or accrual method.

Example. On June 29, 1990, you paid a premium of $3,000 for fire insurance on your barn. The policy will cover a period of 3 years beginning on July 1, 1990. Only the cost for the 6 months in 1990 is deductible as insurance expense on your 1990 tax return. The amount deductible is $500, which is $^{6}/_{36}$ of $3,000 (6 months of the 36–month premium has been used). $1,000 ($^{12}/_{36}$ of $3,000) is then deductible in 1991 and in 1992. The remaining $500 is deductible in 1993. Had the policy been effective on January 1, 1990, the deductible expense would have been $1,000 for each of the years 1990, 1991, and 1992, based on one-third of the premium used each year.

Business interruption insurance. Business interruption insurance premiums are deductible. This insurance compensates you for the loss of profits resulting from the shutdown of your business because of fire or other cause. The proceeds must be reported in full as ordinary income.

Commodity futures contracts (hedging). If, in the normal course of business, you enter into commodity futures contracts primarily to reduce the risk of an unfavorable price fluctuation, you are hedging. This is a form of business insurance. Any loss from a closed hedging futures transaction is an ordinary business loss and entered as a minus amount on line 10 of Schedule F. Any profit is ordinary income and entered on line 10 of Schedule F.

Commodity futures contracts entered into with the hope of making a profit on the contract itself through a favorable price fluctuation are considered held for speculation. These futures contracts are capital investments. See *Commodity Futures* in Publication 550, *Investment Income and Expenses.*

If you, as a farmer-producer, trade in commodity futures contracts within your range of production, the transactions are generally considered hedges. They may take place at any time you have the commodity under production, have it on hand for sale, or reasonably expect to have it on hand. If, however, you trade in commodity futures outside your range of production, you are considered to be speculating.

If you have numerous transactions in the commodity futures market during the year, the burden of proof is on you to show that in each transaction you are actually hedging and not speculating. If you enter into a hedging transaction, you must clearly identify on your books and records, before the end of the day you entered into the transaction, that the transaction is a hedging transaction. If you do not identify it as a hedging transaction, the transaction will be considered speculation.

The following example illustrates one hedging transaction during the year.

Example. On July 2, 1990, you anticipate a yield of 50,000 bushels of corn this crop year. The present December futures price is $2.75 a bushel, but there are indications that by harvest time the price will drop. To protect yourself against a possible price drop, you decide to hedge. To do this, you sell 10 December futures contracts of 5,000 bushels each for a total of 50,000 bushels of corn at $2.75 a bushel.

The price did not drop as anticipated but rose to $3.00 a bushel. In November, you sell your crop at a local elevator for $3.00 a bushel. You also close out your futures position by buying 10 December contracts for $3.00 a bushel. You paid a broker's commission of $700 ($70 a contract) for the complete in and out position in the futures market.

The result is that the price of corn rose 25 cents a bushel—the actual selling price is $3.00 a bushel. Your loss on the hedge is 25 cents a bushel. In effect, the net selling price of your corn is $2.75 a bushel.

You should report the results of your futures transactions and your sale of corn separately on Schedule F.

The loss on your futures transactions is $13,200, figured as follows:

July 3, 1990—Sold Dec. corn futures 50,000 bu. @$2.75	$137,500
Nov. 7, 1990—Bought Dec. corn futures 50,000 bu. @$3.00 (plus broker's commission)	150,700
Futures loss	($ 13,200)

This is an ordinary business loss and should be reported as a negative figure on line 10, Part I of Schedule F.

The proceeds from your corn sale at the local elevator are $150,000 (50,000 bu. × $3.00) and should be reported on line 4, Part I of Schedule F.

Assume you were right and the price went down 25 cents a bushel instead. In effect, you would still net $2.75 a bushel.

Sold cash corn, per bushel	$2.50
Gain on hedge, per bushel	.25
	$2.75

The gain on your futures transaction would have been $11,800, figured as follows:

July 3, 1990—Sold Dec. corn futures 50,000 bu. @$2.75	$137,500
Nov. 7, 1990—Bought Dec. corn futures 50,000 bu. @$2.50 (plus broker's commission)	125,700
Futures gain	$ 11,800

This would be ordinary income and should be reported on line 10, Part I of Schedule F.

The proceeds from the sale of your corn at the local elevator, $125,000, should be reported on line 4, Part I of Schedule F.

Rent and Leasing

If you lease business property, you can generally deduct the rent you pay.

Rent. Rent you pay in cash is deductible on Schedule F. However, rent paid in crop shares is not deductible because the costs of raising the crops have been deducted as farming expenses.

Advance payments. Advance payments of rent, like advance payments of insurance, can be deducted only in the year to which they apply, regardless of your accounting method.

Farm residence. If you rent a farm, the part of the rental expense that represents the fair rental value of the farm residence in which you live is not deductible.

Lease or purchase. If you decide to lease equipment rather than purchase it, you should determine whether the agreement is actually a lease or is, in reality, a conditional sales contract. If the agreement is a lease, you will be entitled to deduct rental payments for the use of the equipment in your trade or business. If the agreement is a conditional sales contract and you have acquired, or will acquire, title to or equity in the equipment, the payments under the agreement, so far as they do not represent interest or other charges, will be considered payments for the purchase of the equipment. You may not deduct these payments as rent, but must capitalize the cost of the equipment and recover this cost through deductions for depreciation.

Example. In 1990, you lease new farm equipment from a dealer who both sells and leases. The lease payments and the specified option p equal the sales price plus interest. Under the lease, you are responsible for maintenance, repairs, and the risk of loss. For federal incom tax purposes, the lease is a sale of the equipm and you may not deduct any of the lease costs rent. You can deduct interest, repairs, insuranc depreciation, and other business expenses.

Intent. Whether the agreement, which in fo is a lease, is in substance a conditional sales contract depends on the intent of the parties a shown by the agreement, read in the light of th facts and circumstances existing at the time th agreement was made. In determining the inten no single test, or special combination of tests, i absolutely definitive. However, in the absence o compelling and persuasive factors to the contr an agreement is considered a conditional sales contract rather than a lease if any of the follow is true.

- The agreement applies part of each payment toward an equity interest you will receive.
- You get title to the property after payment of a stated amount of payments you are required t make.
- You must pay, over a short period of time, an amount that is a large part of what you would pay to buy the property.
- You pay rent that is much more than the curr fair rental value for the property.
- You have an option to buy the property at a price that is small compared to the value of th property at the time you may take advantage o the option. Determine this value at the time of entering into the original agreement.
- You have an option to buy the property at a price that is small compared to the total amou you are required to pay under the lease.
- The lease designates some part of the payments as interest, or part of the payments are easy to recognize as interest.

Finance leases. If your lease agreement qualified as a finance lease before 1988, you can deduct your lease payments as a farm deductio in Part II of Schedule F. A finance lease was treated as a lease for federal tax purposes even it was considered a sale under the rules above. The rules for finance leases applied to leases of farm property entered into after July 1, 1982, an before January 1, 1988.

Leveraged leases. Special rules apply to leveraged leases of equipment (property financ by a nonrecourse loan from a third party). See Revenue Procedure 75-21, 1975-1 C.B. 715 and Revenue Procedure 75-28, 1975-1 C.B. 752 as amended by Revenue Procedure 81-71, 1981-2 C.B. 731.

Motor vehicle leases. Special rules apply to lease agreements that have a terminal rental agreement clause. Generally, the clause will provide for a rental adjustment on termination of the lease. If your rental agreement contains a te minal rental agreement clause, the agreement i treated as a lease. For this purpose, qualified motor vehicles (including trailers) can be registered for use on highways. See section 7701(h) the Internal Revenue Code.

Depreciation

If you use property in your farming business tha has a useful life of more than one year, you gen ally cannot deduct its entire cost in one year. Instead, you must spread the cost over more th one year and deduct a part of it each year. For most property, this deduction is depreciation. However, you may choose to deduct a limited amount of the cost of this property as a busines expense. This is the section 179 deduction.

e all allowable deductions, including depreci-
to figure your net earnings from self-
oyment. You may ***not*** increase your net
ngs from self-employment by claiming less
ctions than are allowable. Depreciation and
ection 179 deduction are discussed in Chap-
. Net earnings from self-employment are
ssed in Chapter 15.

g your home in your business. To deduct
nses for the business use of your home, you
t use part of your home exclusively and regu-
either as:

he principal place of business for any business
n which you engage (even if not your main
business), or

place where you meet or deal with clients or
customers.

eparate structure that is not attached to your
ne, such as a garage, may qualify for business
if used in connection with your business, pro-
d it is used exclusively and regularly for this
pose.

eduction limit. There is a limit on the amount
eductions for operating expenses, deprecia-
, etc., that may be taken for the business use
our home. Total deductions for the business
of your home cannot be more than:
Gross income from the business use of your
me minus the sum of—

The business or rental percentage of the oth-
erwise deductible mortgage interest, real
estate taxes, and casualty losses, and

The business or rental expenses other than
those related to the business use of a home.

ertain expenses for the business or rental use
your home are more than the limit discussed
ove, you can carry the excess amount forward
the next year when computing your deduction
it for that year, whether or not you use your
me as a residence.
See Publication 587, *Business Use of Your
me,* for how to figure this limit and where to
duct the expenses on your return.

ruck and Car Expenses

ou may deduct the cost of operating a truck or
r used in your farm business. Only expenses for
siness use are deductible. All operating and
ed costs allocable to business use are deducti-
e, including such items as gasoline, oil, repairs,
ense tags, insurance, and depreciation.
Instead of using actual costs to determine your
eduction for truck or car expenses, under certain
onditions you may use a standard mileage rate of
6 cents a mile for all miles of business use.
eginning in 1990, the 15,000–mile annual limit no
nger applies.

Travel Expenses

Ordinary and necessary expenses you incur in
raveling away from home for your farming busi-
ess are deductible. However, you may not
deduct expenses that are lavish or extravagant.
Your home, for tax purposes, will usually be where
our farming business is located. You are consid-
ered to be away from home if you are absent from
our farm for substantially longer than an ordinary
work day and your duties require you to get sleep
or rest while away from your business.

If you meet these requirements and can prove
he time, place, and business purpose of your
ravel, you may deduct your reasonable and nec-
essary expenses for travel, meals, and lodging.
However, you can deduct only 80% of your busi-
ness-related meal and entertain-ment expenses.

Travel expenses include such items as:

1) Meals and lodging;
2) Cleaning and laundry;
3) Telephone and telegraph;
4) Transportation (by air, rail, bus, and car) from where you obtain meals and lodging, and your temporary work assignment;
5) Other similar expenses related to ordinary and necessary travel; and
6) Tips incident to any of the above expenses.

Reimbursements to employees. Reimbursements and allowances to your employees for travel and transportation expenses they incur in the conduct of your business are deductible by you as business expenses (subject to the 80% limit). If you require your employees to account for these expenses, you must keep their records and supporting documents to prove deductions on your return for any reimbursements or allowances you paid them.

Recordkeeping requirements. You must be able to prove your deductions for travel, entertainment, and gift expenses by adequate records or sufficient evidence that will support your own statement. Estimates or approximations do not qualify as proof of an expense.

You should keep the proof you need for travel, entertainment, and gift expenses or similar records, supported by adequate documentary evidence, that together will corroborate each element of an expense.

Instead of deducting the actual cost of meals while traveling away from home for business, you may choose to deduct a standard meal allowance. If you choose this option, you do not have to keep records to prove amounts spent for meals. However, you must still prove the actual cost of other travel expenses, as well as the time, place, and business purpose of your travel.

For more information on travel and entertainment, including recordkeeping and the standard meal allowance amounts, get Publication 463, *Travel, Entertainment, and Gift Expenses.*

Other Expenses

The following list, while not all-inclusive, shows some of the expenses that may be deducted as other farm expenses in Part II on page 1 of Schedule F. These expenses must be for business purposes and must be (1) actually paid, if you report on the cash method, or (2) incurred, if you report on the accrual method.

- Accounting fees
- Advertising
- Chemicals
- Custom hire (machine work)
- Educational expenses (maintain and improve farming skills)
- Farm attorney fees
- Farm business travel
- Farm magazines
- Farm organization dues
- Freight and trucking
- Ginning
- Insect sprays and dusts
- Litter and bedding
- Livestock fees
- Recordkeeping expenses
- Service charges
- Small tools having a useful life of one year or less
- Stamps and stationery
- Storage and warehousing
- Tying material and containers
- Veterinary fees and medicine

Soil and Water Conservation

Under certain circumstances, expenses for soil or water conservation or for the prevention of erosion are deductible, if they are consistent with a plan approved by the Soil Conservation Service of the USDA. See Chapter 6.

Marketing Quota Penalties

Penalties paid for marketing crops in excess of farm marketing quotas are deductible on Schedule F as a farm business expense. However, if you do not pay the penalty but the purchaser of your crop deducts it from the amount paid to you, include in gross income only the amount you actually received and do not take a separate deduction for the penalty.

Tenant House Expenses

The expenses of maintaining houses and their furnishings for tenants or hired help are deductible farm business expenses. These expenses include repairs, heat, light, insurance, and depreciation.

Items Purchased For Resale. If you use the cash method, you can deduct the cost of livestock and other items purchased for resale on page 1 of Schedule F in the year of sale. This cost includes freight charges for transporting purchased livestock to the farm. Ordinarily, this is the only time the purchase price can be deducted. However, see *Cost of chickens, seeds, and young plants—cash method,* below.

Example. You report on the cash method. In 1990, you buy 50 steers that you will sell in 1991. You must deduct the purchase price, plus any freight cost, in 1991 when the steers are sold.

Cost of chickens, seeds, and young plants—cash method. The purchase price of hens and baby chicks bought for commercial egg production or for raising and resale may be deducted as an expense by cash method farmers in the year these costs are paid, if this is done consistently and clearly reflects income. The purchase price of seeds and young plants bought for further development and cultivation before sale may also be deducted as an expense when paid if it is done consistently and you do not figure your income on the crop method. However, this rule does not apply to the cost of seeds and young plants for planting Christmas trees, orchards, and timber.

If you deduct the purchase price of chickens and young plants as an expense, you must report their entire selling price as income, without deducting purchase price from selling price. However, see *Prepaid Farm Supplies,* earlier, for a rule that may limit your deduction for the items discussed here. The cost of plants with a preproductive period of more than 2 years must also be capitalized, unless you elect out of the uniform capitalization rules. See *Special Rules for Farm Property,* later, in Chapter 7.

Example. You use the cash method. In 1990, you buy 500 baby chicks to raise for resale in 1991. You also buy 50 bushels of winter seed wheat in 1990 that you sow in the fall. You may deduct the cost of both the baby chicks and the seed wheat in 1990, unless you previously adopted the method of deducting these costs in the year the chickens or the harvested crops are sold.

Delaying deduction—crop method. You may delay deducting the purchase price of hens, chicks, seeds, and young plants until they are sold if you prefer (but you will need to get permission from the IRS). If you follow this method, deduct the purchase price from the selling price to determine your profit. See *Crop method* in Chapter 3. This is done in Part I on page 1 of Schedule F.

Choosing the method. You may adopt either of these methods for deducting the purchase price the first year you buy egg-laying hens, pullets, chicks, or seeds and young plants. If you choose the crop method, however, you will need to get permission from the IRS.

Although you must use the same method for egg-laying hens, pullets, and chicks, you may use a different method for seeds and young plants. Once you use a particular method for any of these items, you must use the same method for these items until you get permission from the IRS to change your method. See *Change in Accounting Method* in Chapter 3.

The purchase price of seeds and young plants for Christmas trees and timber may not be deducted as an expense. The cost of these seeds and plants must be deducted through depletion allowances. See *Depletion* in Chapter 8.

The purchase price of chickens and plants used to furnish food for your family is never deductible.

Retirement Plans

Retirement plans are savings arrangements that permit you to set aside money for you and your employees' retirement. A self-employed farmer can set up the following kinds of retirement plans:

A simplified employee pension (SEP),

A KEOGH retirement plan, and

An individual retirement arrangement (IRA).

Within certain limits, you can take a farm deduction on line 25 of Schedule F for the employer contribution you make to a plan for your employees. This deduction can include contributions made for your spouse if a ***true employer-employee relationship*** exists between you and your spouse. You take a personal deduction on Form 1040 for employer contributions you made for yourself or in the case of an IRA, for your nonworking spouse.

Simplified employee pension (SEP). A SEP is a plan that gives you, as an employer, an easy way to make contributions for an employee's retirement. You make contributions directly to the individual retirement arrangement (SEP–IRA) you or your employee set up with a qualified sponsor (bank, insurance company, etc.). You can also have a SEP–IRA for yourself.

The contributions you make to a SEP–IRA are treated as if made to a qualified (meeting IRS requirements) plan. The amount you can contribute is limited to the lesser of $30,000 or 15% of participant's compensation. However, the maximum amount you can deduct for employer contributions to a SEP is 15% of the compensation (determined without regard to your contributions) of the participants. In addition, the 15% limit is reduced when computing the deduction for yourself as a participant. See the *Employer Deduction* section of Publication 560, *Retirement Plans for the Self-Employed.* Deduct contributions for yourself on line 27 of Form 1040. Deduct contributions for your common-law employees on Schedule F (Form 1040). Contributions you make to a SEP–IRA that exceed your deduction limit for a tax year can be carried over and deducted in later years, subject to the 15% limit.

If you have both a SEP and a profit-sharing plan, you must reduce the 15% limit for the profit-sharing plan by the SEP deductions. If your business has a SEP, a defined contribution plan, and a defined benefit plan, the 25%-of-compensation deduction limit for combinations of qualified plans must be reduced by the SEP deductions.

A SEP may include a salary reduction arrangement. Under the arrangement, your employees may choose to have you make contributions to the SEP–IRA instead of paying them the equivalent amount for salary. In general, the total income an employee can defer under a SEP is limited to $7,979 for 1990. This limit applies only to the amounts that represent a reduction from the employee's salary, not to any contribution from your funds.

Employer's SEP contributions excluded from employee's wages on Form W–2. Your SEP contributions are excluded from an employee's income. Therefore, do not include these contributions in the employee's wages on Form W–2, *Wage and Tax Statement,* for income tax purposes. These contributions are excluded from income for social security (FICA) and federal unemployment (FUTA) tax purposes. However, your SEP contributions under a salary reduction agreement are included in Form W–2 wages for FICA and FUTA tax purposes only.

Since your contributions to the SEP–IRA are not included in the employee's income for income tax purposes, the employee cannot take a deduction for your contributions.

For more information on SEPs, get Publication 560.

KEOGH retirement plans for the self-employed. Generally, to set up a retirement plan that includes your employees and yourself, the plan must meet many requirements to qualify. If you want to set up a specially designed plan, you should seek professional assistance. However, if you use an IRS approved master or prototype plan and follow its provisions, you will generally satisfy the qualification requirements. For more information on master or prototype plans and the qualification rules, get Publication 560, *Retirement Plans for the Self-Employed.*

Individual retirement arrangement (IRA). You may be able to set up your own IRA. To be eligible, you must have compensation that is included in your gross income for the year. Compensation, in general, includes your net earnings from self-employment and any salary.

The most you can contribute each year is the smaller of:

- $2,000, or
- Your taxable compensation for the year.

Amount deductible. The amount of your IRA contribution that you can deduct depends on whether you or your spouse (unless you file separately and live apart throughout the tax year), are covered by a retirement plan at work, and if so, the amount of your income. Also, you may be able to make nondeductible contributions to your IRA. For general information on IRAs, get Publication 590, *Individual Retirement Arrangements (IRAs).*

Losses From Operating a Farm

If you have a loss in the operation of your farm during the year, or you had a casualty or theft loss that was more than your income, you may have a net operating loss (NOL). You can use an NOL to reduce your income (and tax) in other years by carrying it to those years and deducting it from income you have in those years. However, the at-risk limits, discussed below, may limit how much of your NOL you can carry to the other years.

Net operating losses. If your deductions for the year are more than your gross income, you may have an NOL. However, there are rules that limit what deductions you can take when figuring an NOL. These rules are discussed under *How To Figure an NOL* in Publication 536, *Net Operating Losses.*

It is important for you to determine whether
have an NOL. If you have an NOL this year, yo
may be able to get a refund of part or all of the
income tax you paid for the past 3 tax years or
may be able to reduce your tax in future years.

Carrybacks. You generally carry an NOL b
to the 3 tax years before the NOL year and de
it from income you had in those years. There a
rules for figuring how much of the NOL is used
each tax year and how much is carried to the n
tax year. These rules are explained under *How
Use an NOL* in Publication 536.

Unless you choose to forgo the carryback
period (as discussed later), you must first carry
your NOL to the third tax year before the NOL
year. If it is not all used up that year, carry the
unused part to the next year, the second year
before the NOL year. If it is not all used up in t
second year, carry the remaining unused part t
the next tax year, the year before the NOL yea

Refigure your deductions, credits, and tax fo
each of the 3 carryback years to which you ca
an NOL. If your refigured tax is less than the ta
you originally paid, you can apply for a refund b
filing Form 1040X, *Amended U.S. Individual
Income Tax Return,* for each year affected or b
filing Form 1045, *Application for Tentative Ref*
You will usually get a refund quicker by filing F
1045, and you can use one Form 1045 to figu
the overpayments of tax for all 3 carryback ye

Carryovers. If you do not use up the NOL
the 3 carryback years, carry what remains of i
over to the next 15 tax years following the NO
year. Carry it to the first tax year after the NOL
year. If you do not use it up in that year, carry
unused part over to the next year. Continue to
carry over any unused part of the NOL from y
to year until you complete the 15-year carryov
period.

Forgoing the carryback period. You can
choose not to carry back your NOL. If you ma
this choice, you may then use your NOL only i
the 15-year carryover period. To make this ch
attach a statement to your tax return for the y
you have the NOL showing that you choose t
forgo the carryback period. For more informat
about making the choice, see *Forgoing the
carryback period* under *When To Use an NOL*
Publication 536.

Partnerships and S corporations. Partne
ships and S corporations are not allowed to t
an NOL deduction. But the partners or shareh
ers may use their separate shares of the part
ship's or S corporation's loss to figure their
individual NOLs.

At-risk limits. Rules that limit your deductio
losses apply to most business or income-proc
ing activities. Farming is one of the activities c
ered. The at-risk rules limit the amount of los
may deduct when figuring your taxable incom
an NOL. The deductible loss from an activity
limited to the amount you are considered to h
at risk in the activity.

You are generally considered to be at risk
the amount of money and property you contri
to an activity, plus certain amounts borrowed
use in the activity. You are considered at risk
amounts borrowed for use in the activity if yo
personally liable for repayment of the amoun
borrowed or if the amounts borrowed are sec
by your property that is not used in the activit
You are not considered at risk, however, for
amounts borrowed for use in a farming activit
from a person who has an interest in the acti
or a related person to someone (other than y
having such an interest. For more informatio
Publication 925, *Passive Activity and At-Risk
Rules.*

Passive activity limits. If you have a passi
activity, special rules limit the amount of loss
can deduct in the tax year. Losses from pass
activities that exceed income from all other

ssive activities generally cannot be deducted in e tax year. Credits are similarly limited.

A ***passive activity*** is generally any activity volving the conduct of any trade or business in hich you do not materially participate. A rental ctivity is also a passive activity.

There are special rules for interests in activities cquired before October 23, 1986, and certain ntal activities. For more information, get ublication 925.

Capital Expenses

capital expense is an amount paid, or a debt curred, for the acquisition, improvement, or resration of an asset having a useful life of more an one year. Capital expenses are generally not eductible, but they may be depreciable. New unirm capitalization rules also require certain xpenses to be capitalized or included in inventory osts. See Chapters 3 and 7. However, certain apital expenses may be deducted as soil and ater conservation expenses, or if you elect, as a ection 179 deduction. See Chapters 6 and 8.

The following lists some of the usual items hose costs are capital expenses. The costs of aterial, hired labor, and installation of any of ese are also capital expenses.

Land and **buildings**.

Additions, alterations, and **improvements** to buildings, etc.

Automobiles and **trucks**.

Equipment and **machinery**.

Fees for acquiring property, including title costs.

Fences.

Breeding, dairy and **draft** livestock.

Reforestation costs.

Repairs to machinery, equipment, cars, and trucks that prolong their useful life, increase their value, or adapt them to different use.

Water wells, including drilling and equipping costs.

Preparatory costs as follows:

a) Clearing brush, trees, and stumps.
b) Leveling and conditioning land.
c) Purchasing and planting trees.
d) Building irrigation canals and ditches.
e) Laying irrigation pipes.
f) Installing drain tile.
g) Modifying channels or streams.
h) Constructing earthen, masonry, or concrete tanks, reservoirs, or dams.
i) Building roads.

Production expenses. The uniform capitalizaion rules generally require the capitalization of production expenses incurred in producing longerm crops. However, except for certain taxpayers required to use the accrual method of accounting, he capitalization rules do not apply to property with a preproductive period of 2 years or less. For more information, see *Uniform Capitalization Rules* in Chapter 7.

Timber. You must capitalize the cost of acquiring timber. The cost of land is not included in the cost of the timber. You must generally capitalize direct costs incurred in reforestation. These costs include site preparation costs, such as girdling, applying herbicide, baiting rodents, and clearing and controlling brush, the cost of seed or seedlings, and labor and tool expenses including depreciation on equipment used in planting or seeding. You must also capitalize the costs incurred in replanting to replace lost seedlings. Certain indirect costs may be capitalized if you choose. These capitalized amounts are your basis for the timber. You recover your basis when you sell the timber or through depletion allowances when you cut the timber. However, you may be able to recover a limited amount of your costs for forestation or reforestation before this time through amortization deductions. See *Depletion* and *Amortization* in Chapter 8.

For more information about timber, see Agriculture Handbook Number 681, *Forest Owners' Guide To Timber Investments, The Federal Income Tax, and Tax Recordkeeping.* Copies of Agriculture Handbook No. 681 are available from the U. S. Government Bookstore. Place your order using Stock #001-000-04540-7 at the following address:

U. S. Government Bookstore
Room 100
275 Peachtree St. NE
P. O. Box 56445
Atlanta, GA 30343

Christmas tree cultivation. If you are in the business of planting and cultivating Christmas trees for sale when they are more than 6 years old, you must capitalize and add to the basis of the standing trees expenses incurred for planting and stump culture. You recover these expenses as adjusted basis when you sell the standing trees or through depletion allowances as the trees are cut. See *Timber depletion* in Chapter 8. You may deduct as business expenses the costs incurred for shearing and basal pruning of these trees. Expenses incurred for silvicultural practices, such as weeding or cleaning, and noncommercial thinning are also deductible as business expenses.

You should capitalize the cost of land improvements, such as road grading, ditching, and fire breaks, that have a useful life substantially beyond the tax year. If these improvements do not have a determinable useful life, then you should add their cost to the basis of the land, to be recovered when you dispose of it, as in a sale. If they do have a determinable useful life, then you recover their cost through annual allowances for depreciation. The cost of equipment purchased and other depreciable assets such as culverts and fences, as far as they are not used in the planting of Christmas trees, should be capitalized and recovered through allowances for depreciation.

Not-for-Profit Farming

A farmer who operates a farm for profit may deduct all the ordinary and necessary expenses of carrying on the business of farming. However, if your farming activity, or other activity you engage in or invest in, is not carried on to make a profit, the deductions you can take for it are limited and no loss will be allowed to offset other income. Activities you do as a hobby, or mainly for sport or recreation, come under this limit. So does an investment activity intended only to produce tax losses for the investors.

The limit on not-for-profit losses applies to individuals, partnerships, estates, trusts, and S corporations. It does not apply to corporations other than S corporations.

Not for profit. In determining whether you operate your farm for profit, your intentions are important, but all factors relating to your farming activity must be taken into account. No one factor or group of factors is decisive. Among the factors normally considered are:

- Whether you operate your farm in a businesslike manner.
- Whether the time and effort you spend on farming indicates that you intend to make it profitable.
- Whether you depend on income from farming for your livelihood.
- Whether your losses are due to circumstances beyond your control or are normal in the start-up phase of farming.
- Whether you change your methods of operation in an attempt to improve profitability.
- Whether you make a profit from farming in some years and how much profit you make.
- Whether you, or your advisors, have the knowledge needed to carry on the farming activity as a successful business.
- Whether you made a profit in similar activities in the past.
- Whether you are carrying on the farming activity for personal pleasure or recreation.

Limit on deductions and losses. If your activity is not carried on for profit, deductions are allowed only in the following order, only as far as stated in the three categories, and only if you itemize them on Schedule A (Form 1040). You do not have to go through the following computations (Categories 1, 2, or 3) if gross income from the activity is more than your deductions. But you must still itemize them on Schedule A (Form 1040).

Category 1. Deductions you can take for personal as well as business activities are allowed in full. All nonbusiness deductions, such as those for interest and taxes, and the deductible part of casualty losses (see Chapter 13) belong in this category. The amounts allowable for home mortgage interest and personal interest are explained in Publication 545, *Interest Expense*, and Publication 936, *Limits on Home Mortgage Interest Deduction*.

Category 2. Deductions that do not result in an adjustment to the basis of property are allowed next, but only as far as your gross income from the activity is more than the deductions you take (or could take) for it under the first category. Most business deductions, such as those for fertilizer, feed, insurance premiums, utilities, wages, etc., belong in this category.

Category 3. Business deductions that decrease the basis of property are allowed last, but only to the extent that the gross income from the activity is more than deductions you take (or could take) for it under the first two categories. The deductions for depreciation, amortization, and the part of a casualty loss not deductible in the first category belong in this category. Where more than one asset is involved, depreciation and these other deductions must be divided proportionally among those assets.

Partnerships and S corporations. If a partnership or S corporation carries on a not-for-profit activity, these limits apply at the partnership or S corporation level. They are reflected in the individual stockholder's or partner's distributive shares.

Presumption that your farming activity is for profit. Your farming or other activity is presumed to be carried on for profit if it produced a profit in at least 3 of the last 5 tax years including the current year. Activities that consist primarily of breeding, training, showing, or racing horses are presumed to be carried on for profit if they produced a profit in at least 2 out of the last 7 tax years. The activity must be the same for each year within this period. You have a profit when gross income from an activity is more than deductions attributable to it.

If a taxpayer dies before the end of the 5-year (or 7-year) period, the period is considered to have ended on the date of the taxpayer's death.

If your business or investment activity passes this 3 (or 2)-years-of-profit test, it is presumed to be carried on for profit. This means that it will not come under the limits discussed here. You can take all your business deductions from the activity, even for years that you have a loss. You can rely on this presumption, unless the IRS shows it is not valid.

Note: If you fail the 3 (or 2)-years-of-profit test, you still may be considered to operate your farm for profit by considering the factors listed above under *Not for profit.*

Using the presumption at a later time. If you are starting out in farming and do not yet have 3 (or 2) years showing a profit, you may want to take advantage of this presumption at a later time, after you had the 5 (or 7) years of experience allowed by the test.

You can choose to do this by filing Form 5213, *Election to Postpone Determination.* Filing this form postpones any determination that your farming activity is not carried on for profit until 5 (or 7) years have passed since you first started farming. Form 5213 must be filed within 3 years after the due date of your return for the year you first started farming. This form must be filed within 60 days after you receive notice from a District Director proposing to disallow your loss from a farming activity.

The benefit gained by making this choice is that the IRS will not immediately question whether your farming activity is engaged in for profit. Accordingly, it will not limit your deductions from the activity. Rather, you will gain time to earn a profit in 3 (or 2) out of the first 5 (or 7) years you carry on the farming activity. If you show 3 (or 2) years of profit at the end of this period, your deductions will not be limited under these rules. If you do not show 3 (or 2) years of profit (and cannot otherwise show that you operated your farm for profit), the limit will be applied retroactively to any year in the 5–year (or 7–year) period you had a loss.

For more information on not-for-profit activities, see Chapter 1, *Deducting Business Expenses,* in Publication 535.

Personal, Living, and Family Expenses

The law specifically prohibits the deduction of certain personal, living, and family expenses as business expenses. These include rent and insurance premiums paid on property used as your residence, life insurance premiums on yourself or your family, the cost of maintaining automobiles or horses for personal use, allowances to minor children, attorney's fees and legal expenses incurred in personal matters, and household expenses. Likewise, the cost of purchasing or raising produce or livestock consumed by you or your family is not deductible.

Other Nondeductible Items

Loss of growing crops.

Loss of livestock. Loss of livestock raised, if the cost of raising has been deducted as an expense.

Losses from sales or exchanges. Losses from sales or exchanges of property between you and your spouse, brother, sister, ancestor, or descendant.

Repayment of loans.

Costs of raising unharvested crops. Costs of raising unharvested crops sold with land owned more than one year, if both are sold at the same time and to the same person. These costs are added to the basis of the land to determine the gain or loss on the sale. See Chapter 10.

Cost of unharvested crops bought with land. The part of the purchase price of land that is allocable to unharvested crops must be capitalized. This cost may be deducted in figuring net profit or loss in the tax year the crops are sold.

Costs that apply to gifts. Costs that apply to gifts of agricultural products or property held for sale in the ordinary course of business. For example, you may not deduct as a farm business expense, in the year of the gift or any later year, the costs of raising cattle given as a gift to your son or the costs of planting and raising unharvested wheat on parcels of land given as a gift to your children.

Fines and penalties. Fines and penalties paid, except penalties for exceeding marketing quotas.

Estate, inheritance, legacy, succession, and gift taxes.

6. Soil and Water Conservation Expenses

If you are in the business of farming, you may choose to deduct your expenses for soil or water conservation or for the prevention of erosion of land used in farming. Otherwise, these expenses must be capitalized and added to the basis (cost) of the land.

The deduction, however, cannot be more than 25% of your gross income from farming. If the total of these expenses is more than 25% of your gross income from farming, you may deduct the excess in later years. This is explained later under *Carryover of deduction.*

The business of farming defined. You are in the business of farming if you cultivate, operate, or manage a farm for profit, either as owner or tenant.

Farm rental. If you are an owner receiving farm rental, either in cash or crop shares, you are in the business of farming if the rental is based on farm production. If you are an owner and receive a fixed rental not based on farm production, you are in the business of farming only if you participate materially in operating or managing the farm. See *Landlord Participation in Farming* in Chapter 15.

If you receive cash rental for a farm you own that is not used in farm production, you may not claim soil and water conservation expenses for that farm.

Farm defined. A farm includes stock, dairy, poultry, fish, fruit, and truck farms. It also includes plantations, ranches, ranges, and orchards. A fish farm is an area where fish are grown or raised and artificially fed, protected, etc. It does not include an area where fish are merely caught or harvested. A plant nursery specializing in the growing of ornamental plants is a farm.

You are ***not*** farming if you are engaged in forestry or the growing of timber. Nor are you farming if you cultivate or operate a farm for recreation or pleasure, rather than for profit.

Plan certification. Your expenses for soil and water conservation may be deducted only if they are consistent with a plan approved by the Soil Conservation Service (SCS) of the Department of Agriculture. If no such plan exists, the expenses must be consistent with a soil conservation plan of a comparable state agency to be deductible.

Conservation plans. A conservation plan includes the farming conservation practices approved for the area where your farmland is located. There are three types of approved plans:

1) ***SCS individual site plans*** are issued individually to farmers who request assistance from SCS to develop a conservation plan designed specifically for their farmland.
2) ***SCS county plans*** include a listing of farm conservation practices that are approved for the county where the farmland is located. Expenses for conservation practices not included on the SCS county plans are dedu ble only if the practice is a part of an individ site plan. Individual site plans can be obtain from SCS offices and comparable agencies.
3) ***Comparable state agency plans,*** approved by state agencies. These plans may be approved individual site plans or county plan

Form 8645. For each year you claim soil and water conservation expenses, you must comple and attach Form 8645, *Soil and Water Conserva-tion Plan Certification,* to your income tax return. However, if you have a carryover from a previou year, you do not have to complete a new form. Simply attach a copy of the original form to your return. If expenses are paid or incurred primarily produce an agricultural crop, and they also (incidentally) conserve soil, the expenses are not soi and water conservation expenses. You may not deduct them as soil and water conservation expenses and you do not need to file Form 8645.

Deductible expenses. Deductible conservatio expenses are those made for land that you or yo tenant are using, or have used in the past, for farming. They include, but are not limited to:

1) The treatment or movement of earth, such a leveling, conditioning, grading, terracing, contour furrowing, or restoration of fertility,
2) The construction, control, and protection of diversion channels, drainage ditches, irrigatio ditches, earthen dams, watercourses, outlets, and ponds,
3) The eradication of brush, and
4) The planting of windbreaks.

Wetlands. Expenses to drain or fill wetlands o prepare land for center pivot irrigation systems a not deductible.

New farm or farmland. If you acquire a new farm or new farmland from one who immediately prior to the acquisition was using it in farming, soi and water conservation expenses you make on i will be treated as made on land you previously used in farming. The land will qualify for this choice if the use you make of it is substantially a continuation of its use in farming. The new farmin activity does not have to be the same as the old farming activity. For example, if you buy land that had been used for grazing cattle and prepare it fo use as an apple orchard, the expenses will qualify.

Land not used for farming. If you make conservation expenses that benefit land that does no qualify as land used for farming as well as land that does qualify, you must allocate the expenses. For example, if they benefit 200 acres of your lan but only 120 acres of this land are used for farming, then 60% (120/200) of the expenses is deductible. You may use a different method to allocate these expenses if you can clearly show that your method is more reasonable.

Depreciable soil and water conservation assets. You may not deduct your expenses for depreciable conservation assets. You must capitalize your direct expenses for structures or facilities that are subject to an allowance for depreciation, such as depreciable nonearthen items made of masonry or concrete. For example, expenses for depreciable property include those for materials, supplies, wages, fuel, hauling, and dirt moving for making structures such as tanks, reservoirs, pipes, conduits, canals, dams, wells, o pumps composed of masonry, concrete, tile, metal, or wood. You recover your capital investment through annual allowances for depre ation.

However, soil and water conservation expens for earthen items that are nondepreciable may b deducted, such as earthen terraces and dams.

Water wells. You must capitalize your cost of rilling a water well. You may recover your cost rough deductions for depreciation, as explained Chapter 8. You also must capitalize your cost r drilling test holes. If the test holes produce no ater and you continue drilling, the cost of the test oles must be added to the cost of the producing ell. You can recover the total cost through epreciation deductions. If a test hole, a dry hole, r a dried-up well (resulting from prolonged lack of ain, for instance) is abandoned, your unrecovered ost is deductible in the year of abandonment.

You must, however, terminate the existence of he well in such a way that all economic benefits rom it are permanently ended. For example, filling r sealing a well excavation or casing so that all enefits from the well are permanently stopped vould be abandonment.

Assessments by soil and water conservation and drainage districts. In some localities, expenses for soil and water conservation are nade by a soil or water conservation or drainage district, which in turn will levy an assessment against the farmers benefited by these expenses. You may deduct the part of an assessment that would have been deductible as a soil or water conservation expense if you had paid it directly. Depending on your method of accounting, you are entitled to deduct this amount in the year you pay or incur the expense of the assessment, not at the ime the expenses are paid or incurred by the district.

You also may deduct at least part of an assessment levied against you by a soil and water conservation or drainage district to pay for depreciable property such as pumps, locks, concrete structures including dams and weir gates, draglines, and similar equipment. The depreciable property must be used in the district's soil and water conservation activities. Special rules, however, discussed next, apply to these assessments or depreciable property.

Assessments for depreciable property. You must first determine the amount of your overall assessment for depreciable property that is deductible. Your overall deductible assessment cannot be more than 10% of the total assessment made by the district against all members to cover he cost of acquiring this depreciable property. The amount that is more than the 10% limit is a capital expense that you add to the basis of your armland. If an overall assessment is more than he 10% limit and is payable in installments, you must divide each installment into deductible and capital expense amounts.

The amount of assessments that you paid or incurred in a tax year determines whether you may deduct the assessments as soil and water conservation expenses in the year they are paid or incurred or whether you must treat them as soil and water conservation expenses that are deductible over a 10–year period.

Figure 10% of your overall deductible assessment and subtract that amount from the assessment paid or incurred during the tax year. If the balance is $500 or less, you may treat the entire amount of the assessment as soil and water conservation expenses this year.

However, if the balance is more than $500, you include this year only 10% of your overall deductible assessment as soil and water conservation expenses. The balance is treated as soil and water conservation expenses in equal amounts in each of your next 9 tax years.

Example 1. This year a soil conservation district levies an assessment of $2,400 against your farm. Of the assessment, $1,500 is for the digging of drainage ditches. The remaining $900 is for depreciable equipment to be used in the district's irrigation activities. The total amount assessed by the district against all its members for the depreciable equipment is $8,000.

Your deductible assessment for the depreciable equipment is limited to 10% of the total amount assessed by the district against all its members for depreciable equipment, or $800. The $100 excess ($900 − $800) is a capital expense that you must add to the basis of your farm. If the overall assessment were spread over a 10–year period, the deductible assessment would be $80 a year. Since the remaining balance of your deductible assessment, $720, exceeds the $80 amount by more than $500, you may treat only $80 of your assessment as a soil and water conservation expense this year. The balance is deductible at the rate of $80 a year over the next 9 years.

Since $1,500 of the assessment is made to pay for a conservation district expense that would be deductible this year if you had made it, you may treat that part of the assessment as a soil and water conservation expense.

Therefore, you treat $1,580 of the $2,400 assessment as a soil and water conservation expense this year.

Example 2. Assume that $1,850 of the $2,400 assessment in Example 1 is for the digging of drainage ditches and $550 is for depreciable equipment.

The assessment of $550 is less than 10% of the total assessment against all members in the district for the depreciable property. Ten percent of this assessment is $55. The assessment of $550 minus $55 leaves a balance of $495, which is less than $500. Thus, the entire amount assessed for depreciable property is a soil and water conservation expense. You treat the entire amount of the assessment, $2,400, as a soil and water conservation expense this year.

Selling or disposing of land during the 9–year period. If you sell or dispose of the land during the 9–year period when part of a deductible assessment is being deducted, the balance of the assessment that has not been deducted in tax years before the year of sale or disposition is added to your basis in the property. This does not include an amount over the 25% gross income limit, explained later.

Death of farmer during the 9–year period. If the farmer dies during the 9–year period when part of an assessment is being deducted, the balance of the deductible assessment that has not been deducted before the year of death is deducted in the year of death.

Limit on deduction. The total deduction in any tax year of capital expenses for soil and water conservation is limited to 25% of your gross income from farming during the year.

Gross income from farming. Gross income from farming is the income you derive in the business of farming from the production of crops, fish, fruits, other agricultural products, or livestock. Gains from sales of livestock held for draft, breeding, dairy, or sport are included. But gains from sales of assets such as farm machinery, or from the disposition of land, are not included.

Example. Farmer Brown, who uses the cash method of accounting, includes in his "gross income from farming" the following items:

Cash from sale of corn crop	$10,000
Gain from sale of old breeding cows	500
Total gross income from farming	**$10,500**

He excludes from "gross income from farming" the following items, which are included in his gross income:

Gain from sale of tractor	$ 100
Gain from sale of 40 acres	$ 8,000
Interest on loan to Farmer Smith	$ 100

For more information on gross income from farming, see Chapter 2.

Carryover of deduction. You may carry over any unused deduction to later years if your deductible conservation expenses in any year are more than 25% of your gross income from farming for that year. However, the amount deducted in any later year may not be more than 25% of the gross income from farming during the year the deduction is taken.

Example. In 1990 you have gross income of $16,000 from two farms. During the year, you made $5,300 of deductible soil and water conservation expenses for one of the farms. However, your deduction is limited to 25% of $16,000, or $4,000. The $1,300 ($5,300 − $4,000) is carried over to 1991 and added to deductible soil and water conservation expenses made in that year. The total of the 1990 carryover plus 1991 expenses is deductible in 1991, subject to the limit of 25% of your gross income from farming in 1991. Any excess expenses over the limit in that year are carried to 1992 and later years.

Sale of the farm. If you sell your farm and discontinue farming, you may not adjust the basis of the land for any unused carryover of soil and water conservation expenses at the time of the sale. You may, however, pick up the unused balance and start taking deductions again if you return to the business of farming in a later year.

Maintaining conservation structures. Ordinary and necessary expenses for maintaining completed soil and water conservation structures, such as the annual removal of sediment from a drainage ditch, are deductible farm business expenses. They are not subject to the 25% limit. Otherwise deductible expenses are not soil and water conservation expenses. This includes interest and taxes, the cost of periodically clearing brush from productive land, and the cost of primarily producing an agricultural crop that also conserves soil.

To get the full deduction to which you are entitled, you should maintain your records in a way that will clearly distinguish between your ordinary and necessary farm business expenses and your water and soil conservation expenses.

Choosing to deduct. You may choose to deduct your soil and water conservation expenses in one of the following ways:

1) For the first year you pay or incur these expenses, claim them as a deduction on your return. Once you make your choice, you must get the consent of your District Director of the Internal Revenue Service if you want to change it. If you do not deduct these expenses for the first year in which you paid or incurred them, you must capitalize them.
2) If you have been capitalizing these expenses in previous years and now want to claim your current year's expenses as a deduction on your return, you must get the consent of your District Director.

If you choose to deduct your soil and water conservation expenses, you must deduct the total amount allowable in the year the expenses were paid or incurred.

If you want to change your method of treating soil and water conservation expenses, or you want to treat the expenses for a special project or a single farm in a different manner, you must get the consent of your District Director. To get this consent, submit a written request by the due date of your return for the first tax year that you want the different treatment to apply. You or your authorized representative must sign the request. Your request must include the following information:

1) Your name and address,
2) The first tax year you use the different treatment,
3) Whether the different treatment applies to all your soil and water conservation expenses or only to those for a special project or farm. If the treatment does not apply to all your expenses, identify the project or farm to which those expenses apply,

4) The amount of the expenses you paid or incurred in the first tax year for which the changed treatment is to apply, and
5) A statement that you will account separately in your books for the expenses to which this treatment applies.

Gain on the disposition of farmland. If the land was held 5 years or less before you sold or disposed of it, treat gain on the sale or other disposition of the land as ordinary income up to the amount of the deductions you previously took for soil or water conservation expenses or for land clearing expenses. If the land was held less than 10 but more than 5 years, the gain is ordinary income up to a specified percentage of the previous deductions taken. See *Farmland (under section 1252)* in Chapter 11.

7. Basis of Assets

Basis is a way of measuring your investment in property for tax purposes. Use the basis of property to figure the amount of gain or loss on the sale, exchange, or other disposition of property. Also use it to figure the deduction for depreciation, amortization, depletion, and casualty losses.

This chapter is divided into three sections: Cost Basis, Adjusted Basis, and Other Basis. The basis for inventories is discussed in Chapter 3.

Cost Basis

The basis of property you buy is usually its cost. The cost is the amount you pay for it in cash, other property, or services. Your cost also includes amounts you pay for sales tax, freight, installation, and testing. In addition, the cost basis of real estate and business assets will include other items.

Low or no interest loans. If you buy property on any time-payment plan that charges little or no interest, the basis of your property is your stated purchase price minus the amount considered to be unstated interest. You generally have unstated interest if your interest rate is less than 9% compounded semiannually. See *Unstated Interest* in Publication 537, *Installment Sales.*

Real Property

If you buy real property, certain fees and other expenses you pay are part of your cost basis in the property.

Real estate taxes. If you buy real property and agree to pay certain taxes the seller owed on it, the taxes you pay are treated as part of your cost. You may not deduct them as taxes paid.

If you reimburse the seller for taxes the seller paid for you, you can usually deduct them as an expense in the year of purchase. Do not include them in the property cost. In certain cases, you may choose to capitalize taxes you must pay. See Chapter 7 in Publication 535, *Business Expenses.*

Settlement fees or closing costs. Recording fees and legal fees are some of the settlement fees or closing costs included in the basis of property. Some others are:

1) Abstract fees,
2) Charges for installing utility services,
3) Surveys,
4) Transfer taxes,
5) Title insurance, and
6) Any amounts the seller owes but which you agree to pay, such as back taxes or interest, recording or mortgage fees, charges for improvements or repairs, and sales commissions.

You must reasonably allocate these fees or costs between land, buildings, and other property such as timber, fences, minerals, etc., to figure the basis for each asset. Allocate the fees according to the fair market values of the land and other assets at the time of purchase. See *Allocating the Basis,* later. Settlement fees do not include amounts placed in escrow for the future payment of items, such as taxes and insurance.

Assumption of a mortgage. If you buy property and become liable for an existing mortgage on the property, your basis is the cash amount you pay for the property plus the amount to be paid on the mortgage you assume.

Example. If you buy a building for $20,000 cash and assume a mortgage of $80,000 on it, your basis is $100,000.

Constructing assets. If you build a home or other nonbusiness property or build business property, or have these assets built for you, your expenses for this construction are part of your cost basis. Some of these expenses include:

Land,

Architect's fees,

Building permits,

Payments to contractors,

Payments for rental equipment, and

Inspection fees.

In addition, if you use your employees or farm materials and equipment to construct a business or nonbusiness asset, other expenses that are part of your cost basis include:

1) Employee compensation for work on the asset,
2) Depreciation deductions on equipment you own while it is used in the construction,
3) Operating and maintenance costs for equipment used in the construction, and
4) The cost of business supplies and materials consumed in the construction.

If you use business supplies and materials to construct an asset, or pay employees to construct an asset, you may not deduct these expenses as current business expenses. These expenses are part of your basis in the asset. You must reduce your basis by any jobs credit allowed on the wages you pay these employees.

Allocating the Basis

If you buy property that includes land, depreciable property, a personal residence, and other items for a lump-sum price, you must allocate the cost among the items you buy. Your allocation is based on the ratio of the fair market value of each item at the time you buy it to the total fair market value of all the property you buy. This allocation is necessary to figure the basis of the items for depreciation purposes and to figure the gain or loss on a later sale or other disposition of any item.

Example. You bought farm property on March 1, 1990, for the lump-sum price of $275,000. You use the cash method of accounting. An inventory of the property at its fair market value (FMV) on the date of purchase is as follows:

Growing wheat crop	$ 1
Timber	5
Minerals (such as gravel, coal, sand, etc.)	8
Farmland	170
Farm residence	30
Depreciable assets used in farming	60
Total purchase price	$275

The fair market value of each asset is the cost basis assigned to that asset.

The growing wheat was harvested and sold i July 1990. Therefore, its cost of $1,400 must be deducted on Schedule F to figure the net farm profit for 1990.

The timber was also sold in July 1990. Accordingly, its cost of $5,600 must be taken i account to figure the gain realized or the loss sustained.

The cost of the minerals purchased will be recovered when the mineral interest is sold or erwise disposed of in a taxable exchange. If m erals are produced, the cost will be recovered through depletion allowances. See Chapter 8.

The cost basis assigned to the depreciable assets used in the farming business, $60,000, be allocated (based on fair market values) amo the various assets involved. Each asset's shar the cost basis is its basis for figuring depreciat and gain or loss on its sale.

Embryo transplants. If you acquire an embry transplant by purchasing a recipient cow pregn with the embryo, you must allocate to the cost basis of the cow the portion of purchase price equal to the fair market value of the cow. Alloca the remainder of the purchase price to the bas the calf. Neither the cost allocated to the cow n the cost allocated to the calf is currently deduc ble as a business expense.

Quotas and allotments. Certain areas of the country have quotas or allotments for such com modities as milk and tobacco. These are intang ble property rights and are generally not subjec amortization or depreciation. The cost of the q or allotment is its basis. If you acquire a right to quota with the purchase of land or a herd of da cows, you must allocate part of the purchase p to that right.

Uniform Capitalization Rules

You are subject to the uniform capitalization ru for costs incurred after 1986 if you:

1) Produce real property or tangible personal property for use in a trade or business or a activity engaged in for profit,
2) Produce real property or tangible personal property for sale to customers, or
3) Acquire property for resale.

You produce property if you construct, build, install, manufacture, develop, improve, create, raise, or grow the property. Property produced you under contract is treated as produced by y to the extent you make payments or otherwise incur costs from the property.

Real property is land and generally anything that is erected on, growing on, or attached to Examples of real property you might produce (build) for use in your farming business are ba chicken houses, and storage sheds.

Tangible property is any property that can b seen or touched. Personal property is propert such as equipment or animals that are not re property. Examples of tangible personal prop you might produce for use in your farming bu ness or for sale to customers include crops r for sale or as animal feed, animals raised for (beef cattle, hogs, etc.), or animals used in yo ming business for breeding or production poses (dairy cows).

For the farming business, the uniform capitaliza- n rules generally apply to the production, wing, or raising of property if the property:

) Has a preproductive period of more than 2 years, or

) Is produced by a corporation, partnership, or tax shelter required to use the accrual method of accounting.

nder the uniform capitalization rules, you must pitalize (add to the basis of property) direct sts and an allocable portion of most indirect sts you incur because of your production or sale activities. This means that certain expenses u have during the year will be included in the asis of property you produce or in your inventory osts, rather than claimed as a current deduction. ou can recover these costs through depreciation, mortization, or cost of goods sold, when you use, ell, or otherwise dispose of the property.

Costs that are allocable to property being pro- uced include both variable costs, such as feed, nd fixed costs, such as depreciation on machin- ry and buildings. Your fixed and variable costs re shown in Part II of Schedule F (Form 1040).

The following discussion explains how certain osts are treated under the uniform capitalization ules and the special rules that apply to farmers. or more information on these rules, see the regu- ations under section 263A of the Internal Reve- ue Code, which contain detailed descriptions of he methods that may be used to allocate costs.

xceptions. The uniform capitalization rules do ot apply to: property used for personal or non- usiness purposes, such as your personal resi- ence; certain developmental costs of mineral roperty; property produced under a long-term ontract; costs connected with personal property cquired for resale if the average annual gross eceipts do not exceed $10 million; and costs of aising, growing, or harvesting trees other than rnamental trees or trees bearing fruit, nuts, or ther crops. See *Special Rules for Farm Property*, ater, and Publication 551 for other property not ubject to these rules.

irect costs. Direct material costs and direct abor costs incurred for production or resale ctivities must be capitalized. All other costs are ndirect costs. Direct material costs include the ost of materials that become an integral part of he asset plus the cost of materials used in the rdinary course of the activity.

Direct labor costs include the cost of labor that an be identified or associated with a particular ctivity. This includes all types of compensation basic, overtime, sick, vacation, etc.) plus payroll axes and payments to a supplemental unemploy- ment benefit plan.

ndirect costs. Certain types of costs may irectly benefit, or be incurred because of a partic- lar activity even though the same costs also ben- fit other activities. Therefore, these costs require reasonable allocation to determine the portion ttributable to each of your activities.

Indirect costs that must be capitalized for pro- uction or resale activities include, but are not lim- ed to, amounts incurred for:

1) Repair and maintenance of equipment or facilities.
2) Utilities (heat, light, power, etc.) relating to equipment or facilities.
3) Rent of equipment, facilities, or land.
4) Indirect labor and contract supervisory wages including payroll taxes and payments to supplemental unemployment benefit plans.
5) Indirect materials and supplies.
6) Tools and equipment not otherwise capitalized.
7) Quality control and inspection.
8) Taxes otherwise allowable as a deduction (other than state, local, and foreign income taxes) that relate to labor, materials, supplies, equipment, land, or facilities. This does not include taxes treated as part of the cost of property.
9) Depreciation, amortization, and cost recovery allowance on equipment and facilities to the extent deductible.
10) Depletion (whether or not in excess of cost).
11) Insurance on your plant, machinery or equipment, or insurance on a particular activity.
12) The following items incurred for production or resale activities—storage and warehousing costs, purchasing costs, handling, processing, assembly, and repackaging costs, and a portion of general and administrative costs.

Costs provided by a related person. If a related person provides you with materials, labor, or services for a price less than the arm's-length charge (what you would pay to an unrelated person), both you and the related person must account for the transaction as if you purchased the items for their arm's-length charges. For example, you must capitalize an amount equal to the arm's-length charge for the items and the related person must include in income an equal amount.

Costs not capitalized. Costs not required to be capitalized for production or resale activities include amounts incurred for:

1) Marketing, selling, advertising, and distribution expenses.
2) General and administrative expenses (other than those determined to be indirect expenses, discussed earlier), and compensation paid to officers for the performance of services not directly benefiting or not incurred by a particular production activity.
3) Casualty and theft losses, and other losses allowed by Internal Revenue Code section 165.
4) Depreciation, amortization, and cost recovery allowances on equipment and facilities that were placed in service but are temporarily idle.
5) Income taxes.
6) Repair expenses that do not relate to the manufacture or production of property.

Special Rules for Farm Property

The special rules for farm property apply ***only*** if you are ***not*** required to use the accrual method of accounting, explained next. The special farm uniform capitalization rules apply to property (other than animals) produced in a farming business if the property has a preproductive period of more than 2 years. Therefore, you can claim a current deduction for expenses if the property has a preproductive period of 2 years or less or you elected out of the uniform capitalization rules. See *Preproductive period*, later.

Entities required to use accrual method. The following entities that are required to use the accrual method of accounting (see Chapter 3) must use the uniform capitalization rules regardless of the preproductive period or whether the property is animals.

1) Corporations,
2) Partnerships that have a corporation as a partner, and
3) Tax shelters.

A farming business is considered a tax shelter if it is a farming syndicate, or

1) A partnership or other entity,
2) Any investment plan or arrangement, or
3) Any other plan or arrangement.

This applies if the principal purpose of the partnership, entity, plan, or arrangement is the avoidance or evasion of federal income tax.

Farming Business

For purposes of the uniform capitalization rules, a farming business means a trade or business involving the cultivation of land or the raising or harvesting of any agricultural or horticultural commodity. Examples include the business of:

1) Operating a nursery or sod farm,
2) The raising or harvesting of crops,
3) The raising or harvesting of trees bearing fruit, nuts, or other crops,
4) The raising of ornamental trees, and
5) The raising, shearing, feeding, caring for, training, and management of animals.

An evergreen tree over 6 years old when severed from its roots is not treated as an ornamental tree regardless of the purpose for which it is sold. The processing of commodities or products beyond activities normally incident to the growing, raising, or harvesting of these products is not considered a farming business.

Example 1. C, an individual, is in the business of growing and harvesting apples and other fruits. C also processes the fruits which he harvests to produce apple sauce and similar food products that he sells to customers in the course of his business. Although C is in the farming business for the growing and harvesting of apples and other fruits, C is not in the farming business for processing the fruit products he sells.

Example 2. B, an individual, is in the business of raising livestock. B uses the livestock in a meat processing operation in which the livestock are slaughtered, processed, and packaged for sale to customers. Although B is in the farming business for the raising of livestock, B is not in the farming business for the meat processing operation.

Preproductive Period

You must capitalize the direct and indirect costs incurred during the preproductive period. These costs are added to the basis of your plant or included in your inventory costs if you have an inventory. You can recover these costs through depreciation or cost of goods sold. When the plant becomes productive, current expenses allocable to the plant are deductible.

The preproductive period of property produced in a farming business is:

1) For a plant that has more than one crop or yield, the period before its first marketable crop or yield, or
2) For any other plant, the period before it is reasonably expected to be disposed of.

The preproductive period of a plant begins when you first plant or acquire the seed or plant. The preproductive period ends when the plant becomes productive in marketable quantities or is reasonably expected to be sold or otherwise disposed of.

Animals

Unless you are a corporation, partnership, or tax shelter that must use the accrual method of accounting, your costs in raising animals are exempt from the uniform capitalization rules if incurred after December 31, 1988, in tax years ending after that date. If you previously elected to use the safe-harbor livestock method to account for your costs in raising animals, see the discussion later for rules you must follow.

Election out of uniform capitalization rules. If you were not required to use the accrual method of accounting, you could have elected not to apply the uniform capitalization rules. This election allowed you to currently deduct the costs of raising animals. However, if you made this election, you were required to use the alternate MACRS to depreciate property placed in service during any year the election was in effect. You must treat the disposition of any qualifying animal as section 1245 property and 'recapture' the preproductive expenses you would have capitalized.

Election revoked. If you revoked this election for your first tax year beginning after December 31, 1988, you must continue to use the alternative depreciation method for any property placed in service during any tax year the election was in effect.

You can use any permissible depreciation method for property placed in service after December 31, 1988. Upon disposition of any heifers raised or purchased during the period the election was in effect, you must also recapture the preproductive expenses deducted while the election was in effect.

Example. You raise beef cattle and use the calendar tax year. In 1987, you elected not to apply the uniform capitalization rules to the costs of raising heifers. During the period the election was in effect, you bought a new tractor and began depreciating it under the alternate MACRS method. You figured the costs of raising heifers was $90 in the year a calf was born and $150 in the first tax year after birth.

In 1989, you revoked your election. You must continue to depreciate the tractor under the alternate depreciation method. You must keep preproductive cost records for all heifers born during the period the election was in effect (1987 and 1988). These heifers are treated as section 1245 property and you must recapture the preproductive costs when you dispose of them ($240 for heifers born in 1987 and $90 for heifers born in 1988).

Safe-harbor livestock method. If you were not required to use the accrual method of accounting, you could have elected to use the safe-harbor livestock method to account for your costs of raising beef or dairy heifers in 1987 and 1988. The amounts set under this method were either capitalized or included in the cost of inventory. If you elected this method, you must depreciate the costs capitalized in tax years beginning before January 1, 1989. That is, you begin depreciation when the heifer drops her first calf. Under MACRS, breeding and dairy cows have a 5-year life. See Chapter 8.

Under this method, the amounts capitalized were subtracted from your deductible expenses on Schedule F (Form 1040). These amounts were:

Beef cattle. If you elected the safe-harbor method for beef cattle, your cost per heifer was $340 capitalized over the following periods:

1) $85 (one-quarter) in the tax year the calf was born,
2) $170 (one-half) in the first tax year after birth, and
3) $85 (one-quarter) in the second tax year after birth.

Dairy cattle. If you elected the safe-harbor method for dairy cattle, your cost per heifer was $540 capitalized over the following periods:

1) $135 (one-quarter) in the tax year the calf was born,
2) $270 (one-half) in the first tax year after birth, and
3) $135 (one-quarter) in the second tax year after birth.

Purchased cattle. If you elected the safe-harbor method for raised cattle, and also purchased heifers to be raised to maturity, you treated the date of purchase as the date of the calf's birth. For the first year, you capitalized the greater of:

1) The purchase price of the calf, or
2) The safe-harbor amount ($85 for beef and $135 for dairy).

The safe-harbor amounts were used in the following years. This rule applied regardless of when you purchased the calf during the tax year.

Example 1. You use the calendar tax year and elected the safe-harbor method in 1987 for raised beef cattle. In 1987, you purchased a heifer calf, to be used for breeding, for a cost of $95. You capitalized $95 in 1987, and $170 in 1988, for a total of $265. Because you spent more than the safe-harbor amount in the first year, you did not reduce your deductible expenses in 1987 for this heifer.

Example 2. The facts are the same as Example (1) except that you paid $40 for the calf. In this case, you capitalized the safe harbor amount, $85, and reduced your otherwise deductible expenses by $45. This is the difference between what you spent and the allowable safe-harbor amount ($85 − $40).

Fiscal-tax year. The uniform capitalization rules (or the safe-harbor values) do not apply to costs incurred after December 31, 1988. If you use a tax year that began before December 31, 1988, and ended after January 1, 1989, you could account for the costs incurred in that year in one of two ways:

1) Using the safe-harbor values for your entire tax year, without regard to whether costs were incurred on, before, or after January 1, 1989, or
2) Using the safe-harbor values only for the portion of your tax year before January 1, 1989. Costs incurred on or after January 1, 1989, can be accounted for under any other acceptable method.

Damaged Crops

The uniform capitalization rules do not apply to costs incurred because of freezing temperatures, disease, drought, pests, or casualty. These are the costs you incur for the replanting, cultivation, maintenance, and development of any plants bearing an edible crop for human consumption that were lost or damaged while in your hands. This includes, but is not limited to, plants that make up a grove, orchard, or vineyard.

The replanting or maintenance costs may be incurred on property other than the property that was damaged or lost. This is allowed if the undamaged acreage is not in excess of the acreage of the property on which the damage or loss occurred.

Ownership. Generally, costs must be incurred by the person owning the property at the time the plants were lost or damaged. However, costs will qualify if they are incurred by a person other than the majority owner of the plants at the time of damage or loss if:

1) The person who owned the plants at the time the damage or loss occurred owns an equity interest of more than 50% in such plants or crops, and
2) The other person owns any portion of the remaining equity interest and materially participates in the replanting, cultivation, maintenance, or development of such plants or crops.

Election Out of Uniform Capitalization Rules

If you are not a corporation, partnership, or
shelter required to use an accrual method o
accounting, you can elect not to have the u
capitalization rules apply to any plant produ
a farming business that you conduct. This e
does *not* apply to any costs incurred for the
planting, cultivation, maintenance, or develo
of any citrus or almond grove (or any part th
within the first 4 years that the trees were p
If a citrus or almond grove is planted over a
of years, the portion of the grove planted in
one tax year is treated as a separate grove
purposes of determining the year of plantin

Making the election. Unless you obtain c
from the IRS, this election can only be mad
your ***first*** tax year during which you are in a
farming business that includes the producti
property subject to the uniform capitalizatio

The election must be made on Schedule
Schedule F, or other schedule that you are
required to use for the first tax year that the
tion is effective. In the case of a partnershi
corporation, the election must be made by
partner or shareholder.

If you are eligible to make this election, y
be treated as having made the election if y
not capitalize the costs of producing your f
business property under the uniform capita
rules.

Example. Brian Dey, an individual farme
the calendar tax year. From 1975 until 199
grew only wheat and corn. Because the
preproductive period for these crops is less
years, Brian was not subject to the uniform
talization rules. Beginning in 1990, Brian be
growing grapes. Brian is now subject to the
form capitalization rules unless he elects o
the rules beginning with his 1990 tax year.

Revocation of election. Once you have
to not have the uniform capitalization rules
you can only revoke this election with cons
from the IRS.

Disposition of plants. If you made the el
not to apply the uniform capitalization rules
must treat any plant that you produce as s
1245 property. Further, you must "recaptur
preproductive expenses that you would ha
talized if you had not made the election by
these expenses as ordinary income when
determine your gain on selling or disposing
property.

Depreciation under election. If you or a
person makes the election out, you must u
alternate MACRS (see Chapter 8) to depre
property used predominantly in any farmin
ness owned by you or the related person.
applies to all property placed in service in
year that the election is in effect. This will
vent you from taking the section 179 dedu
expense certain depreciable business ass

Related person. For purposes of this e
a related person is:

1) You and members of your family which
include your spouse and any of your c
who have not reached the age of 18 a
last day of the tax year,
2) Any corporation (including an S corpor
50% or more of the stock (in value) is
directly or indirectly by you or member
your family,
3) A corporation and any other corporati
is a member of the same controlled g
and
4) Any partnership if 50% or more (in val
the interests in the partnership is own
directly or indirectly by you or member
your family.

Example 1. Peter Smith, an individual, has an ple orchard. In addition, Peter grows and har- sts wheat and other grains. The preproductive riod of Peter's orchard is more than 2 years. ter elects not to have the uniform capitalization es apply to the costs of growing new apple es. Peter is required to use alternate MACRS to preciate all property used predominantly in his ming business (including the growing and har- sting of wheat) if this property is placed in rvice during a year that the election is in effect.

This means that all assets and equipment and y equipment used to grow and harvest wheat t is placed in service during a year that the ction is in effect, must be depreciated using the aight line method over the required number of ars as provided by the alternative depreciation stem.

Example 2. Assume the same facts as in ample 1, except that Peter and members of his mily also own 51% (in value) of the interests in rtnership K. Partnership K is engaged in the siness of growing and harvesting corn. There- e, Partnership K is required to use the alterna- e depreciation system for any property used edominantly in its farming business that is ced in service during a year that the election de by Peter is in effect.

djusted Basis

fore you can figure any gain or loss on a sale, change, or other disposition of property or figure owable depreciation, depletion, or amortization, u must usually make certain adjustments to the sis of the property. The result of these justments to the basis is the adjusted basis.

ncreases to Basis

e basis of any property is increased by all items operly added to a capital account. This includes e cost of any improvements having a useful life more than one year and amounts spent after a sualty to restore the damaged property.

Some items added to the basis of property are:

1) The cost of extending utility service lines to property,
2) Legal fees, such as the cost of defending and perfecting title, and
3) Legal fees for obtaining a decrease in an assessment levied against property to pay for local improvements.

If you make additions or improvements to busi- ss property, you must keep separate accounts r these and depreciate the basis of each ccording to the depreciation rules in effect when e addition or improvement was placed in rvice. For more information, see Chapter 8.

ssessments for local improvements. Assessments for items such as paving roads and nstructing ditches, which tend to increase the alue of the property assessed, must be added to e basis of the property and not deducted as xes. However, assessments for maintenance or pair or for meeting interest charges on the mprovements are deductible as taxes.

educting vs. capitalizing costs. You cannot dd to your basis costs that are deductible as urrent expenses. However, there are certain osts that you can choose either to deduct or to pitalize. If you capitalize these costs, include em in your basis. If you deduct them, do not clude them in your basis. See Chapter 9 in ublication 535, *Business Expenses.*

Decreases to Basis

You must decrease the basis of your property by any items that represent a return of capital. Some of these include:

1) The section 179 deduction,
2) Investment credit (part or all of credit) taken,
3) Casualty and theft losses,
4) Easements granted,
5) Recognized losses on involuntary exchanges, and
6) Deductions previously allowed (or allowable) for amortization, depreciation, and depletion.

You also decrease the basis if you receive a rebate from the manufacturer or seller, or if you receive a ***patronage dividend*** as a result of a purchase of property. This is actually a reduction of your purchase price. See *Patronage dividends* in Chapter 4.

Section 179 deduction. If you elect to take the section 179 deduction for any part of the cost of property, decrease the basis of the property by the amount of the section 179 deduction. For more information, see *Section 179 Deduction* in Chapter 8.

Casualties and thefts. If you have a casualty or theft loss, you must decrease the basis of your property by the amount of any insurance or other reimbursement you receive and by any deductible loss not covered by insurance. However, increase your basis for amounts you spend after a casualty to restore the damaged property. See Chapter 13.

Easements. The amount you receive for granting an easement is usually considered to be from the sale of an interest in your real property. It reduces the basis of the affected part of the property. If the amount received is more than the basis of the part of the property affected by the easement, your basis is reduced to zero and the excess is a recognized gain. See *Easements and rights-of-way* in Chapter 4.

Depreciation. You must decrease the basis of your property by the amount of depreciation you have deducted, or could have deducted, on your tax returns under the method of depreciation you selected. If you deducted more depreciation than you should have, decrease your basis by the amount you should have deducted plus part of the excess that resulted in a decrease in your tax liability for any year. If you took less depreciation than you could have, you must still decrease your basis by the amount you could have deducted. If you did not take a depreciation deduction, figure the amount of depreciation you could have deducted.

In decreasing your basis for depreciation, be careful to take into account not only the amount deducted on your tax returns as depreciation expense, but also any depreciation you were required to capitalize under the uniform capitalization rules.

Diesel-powered vehicle. If you received an income tax refund or credit for buying a diesel-powered vehicle, reduce your basis in the vehicle by the amount of the credit or refund allowable. For more information about this credit or refund, see Publication 378, *Fuel Tax Credits and Refunds.*

Other Basis

There are many times when you cannot use cost as a basis. In these cases, the fair market value of the property or the adjusted basis of certain property may be important.

Fair market value. The fair market value is the price at which the property would change hands between a buyer and a seller, neither being required to buy or sell, and both having reasonable knowledge of all necessary facts. Sales of similar property, on or about the same date, may help to figure the fair market value of the property.

Property changed to business use. If you change nonbusiness property to a business use or to income-producing property, such as renting your farm dwelling, the basis for figuring depreciation on the property is the lesser of its adjusted basis or its fair market value on the date of the change in use.

Property received for services. If you receive property for services, you must include the property's fair market value in income. The amount you include in income becomes your basis. If the services were performed for a price agreed on beforehand, it will be accepted as the fair market value of the property if there is no evidence to the contrary.

Taxable Exchanges

A taxable exchange is one in which the gain is taxable, or the loss is deductible. If you receive property in exchange for other property in a taxable exchange, the basis of the property you receive is usually its market value at the time of the exchange. A taxable exchange occurs when you receive cash, or property that is not similar or related in use to the property exchanged.

Example. You trade a tract of farmland with an adjusted basis of $3,000 for a tractor that has a fair market value of $6,000. You must report a taxable gain of $3,000 for the land. The tractor has a basis of $6,000.

Nontaxable Exchanges

A nontaxable exchange is an exchange in which any gain is not taxed and any loss cannot be deducted.

The exchange must meet the following conditions to be nontaxable:

1) The property must be business or investment property. You must hold the property you exchange and the property you receive for business or investment purposes. You may not use either property, such as your home or family car, for personal purposes.
2) The property must be "like-kind" property. The exchange of real estate for real estate or personal property for similar personal property, is a trade of like property. The exchange of an apartment house for a store building, or a panel truck for a pickup truck, is a like-kind exchange. The exchange of a piece of machinery for a store building is not a like-kind trade. The exchange of livestock of one sex for livestock of a different sex is not a like-kind exchange.
3) The property must be tangible property. These rules and benefits generally do not apply to exchanges of stocks, bonds, notes, or certain other intangible property.
4) The property must not be property held for sale. The property you exchange and the property you receive must not be property you sell to customers, such as merchandise. It must be property held for use in your business or for investment.
5) The property you receive must meet identification requirements. The property to be received in the exchange must be identified on or before the day that is 45 days after the date of transfer of the property you exchange.
6) The trade must meet the completed transaction requirement. The property to be received in the exchange must be received before the earlier of:

a) The 181st day after the date of transfer of the property you exchange, or

b) The due date, including extensions, for your tax return for the tax year the property you exchange is transferred.

Example. You traded a machine in which you had an adjusted basis of $8,000 for another like-kind machine that had a fair market value of $9,000. Both machines were used in your farming business. The basis of the machine received is $8,000, the same as the machine traded.

Property plus cash. If you trade property in a nontaxable exchange and pay an additional amount, the basis of the property you receive is the basis of the property you exchanged increased by the additional amount you paid.

Example. If you trade in a truck that has an adjusted basis of $3,000 for another truck that has a fair market value of $7,500, and also pay $4,000 cash for the new truck, the basis of the new truck is $7,000 (the $3,000 basis of the old truck plus the $4,000 cash paid).

Special rules for related persons. Generally, when related persons exchange like-kind property, the nontaxable exchange rules apply. However, for exchanges made directly or indirectly between related persons after July 10, 1989, the exchange is disqualified from this treatment if either party disposes of the like-kind property within 2 years after the exchange. Each related person must report any gain or loss not recognized on the original exchange on the tax return filed for the year in which the later disposition occurred. If this special rule applies, your basis in the property received in the original exchange will be its fair market value.

These rules generally do not apply to dispositions due to:

1) The death of either related person,
2) Involuntary conversions, or
3) Exchanges whose main purpose is not the avoidance of federal income tax.

Related persons. Generally, related persons are ancestors, lineal descendants, brothers and sisters (whole and half blood), and a spouse.

For other related persons, such as a corporation, an individual and a corporation, a grantor and fiduciary, etc., see the rules relating to losses under *Sales and Exchanges Between Related Parties* in Chapter 2 of Publication 544, *Sales and Other Dispositions of Assets.*

Exchange of business. The exchange of assets of one business for the assets of another business is an exchange of multiple assets and cannot be treated as a disposition of a single property. The various assets that comprise each business must be checked to determine which are like-kind exchanges.

The assets treated as transferred in exchange for like-kind property are excluded from the allocation rules. See the discussion under *Trade or Business Acquired* under *Allocating the Basis* in Publication 551, *Basis of Assets.* However, property that is not like-kind property is subject to the allocation rules.

Partially Nontaxable Exchange

A partially nontaxable exchange is an exchange in which you receive unlike property or money in addition to like property. The basis of the property you receive is the same as the basis of the old property with the following adjustments:

Decreased by:

a) Any money you received, and

b) Any loss recognized on the exchange.

Increased by:

a) Any additional costs incurred, and

b) Any gain recognized on the exchange.

The assumption of your liabilities (including a nonrecourse obligation) by the other party to the transaction is treated as money transferred to you in the exchange.

Example 1. You traded farmland in which you had a basis of $10,000 for another tract of farmland that had a fair market value of $11,000. You also received $3,000 in cash. Your gain is $4,000 ($11,000 + $3,000 – $10,000). Your gain is included in income only to the extent of the cash received. The basis of the land received is figured as follows:

Basis of land traded	$10,000
Minus: Cash received	3,000
	$ 7,000
Plus: Gain recognized	3,000
Basis of land received	$10,000

Example 2. You traded a truck in which you had an adjusted basis of $2,750 for another truck that had a fair market value of $2,000. You also received $1,000 cash. Your gain is $250 ($2,000 + $1,000 – $2,750). The basis of the truck you received is figured as follows:

Adjusted basis of truck traded	$2,750
Minus: Cash received	1,000
	$1,750
Plus: Gain recognized	250
Basis of truck received	$2,000

Allocation of basis. The basis must be allocated among the properties, other than money, that you received in the exchange. In making this allocation, the basis of the unlike property is its fair market value on the date of the exchange. The remainder is the basis of the like property.

Example. You had an adjusted basis of $15,000 in a tractor you traded for another tractor that had a fair market value of $12,500. You also received a truck that had a fair market value of $3,000, and $1,000 cash. You have a gain of $1,500 ($16,500 – $15,000) recognized on the exchange. Your basis in the properties you received is:

Adjusted basis of old tractor	$15,000
Minus: Cash received	1,000
	$14,000
Plus: Gain recognized	1,500
Total basis of properties received	$15,500

You must allocate the total basis of $15,500 between the tractor and the truck. The basis of the truck is its fair market value, $3,000, and the basis of the tractor is the remainder, $12,500.

Applicable asset acquisition rules. The applicable asset acquisition rules discussed earlier do not apply to a group of assets that constitute a trade or business if the nontaxable exchange rules apply to all the assets transferred. However, if the nontaxable exchange rules do not apply to all the assets transferred, then the applicable asset acquisition rules do apply. Use Form 8594 for the group of assets not subject to the nontaxable exchange exception.

Exchange—Loss Not Recognized

If you have an exchange that results in an unrecognized loss, the basis of the new property is the basis of the old property decreased by any money received. Allocate this basis among the properties, other than money, received in the exchange. In making this allocation, the basis of unlike property is its fair market value on the date of the exchange. The remainder is the basis of the like property.

Example. You exchanged a tract of farml in which you had an adjusted basis of $18,000 a smaller tract of farmland that had a fair mark value of $14,000. You also received a car for p sonal use that had a fair market value of $2,50 and $500 cash. The loss of $1,000 ($17,000 – $18,000) is not recognized. Your basis in the properties you received is:

Adjusted basis of old land	$18
Minus: Cash you received	
Total basis of properties received	$17

Of the total basis of $17,500, $2,500 is for the you received and the remaining $15,000 is the basis of your new tract of land.

Trade-in or Sale and Purchase

You cannot increase the basis of property by s ing your old property outright to a dealer and th buying the new property from the same dealer, the sale and purchase are actually a single tra action. If the sale to the dealer of your old prop erty and your purchase from that dealer of the new property are dependent on each other, you are considered to have traded your old propert The transaction is treated as an exchange no matter how it is carried out. You cannot avoid th trade-in rule by using a subsidiary.

Example. Assume that you used a tractor o your farm for 3 years. Its adjusted basis is $2,0 and its market value is $4,000. You are interes in a new tractor with a listed retail price of $16,0 that regularly sells for $15,500. If you trade you old tractor for the new one and pay the dealer $11,500, your basis for depreciation for the new tractor is $13,500 ($11,500 cash plus the $2,00 basis of your old tractor). However, you want a higher basis for depreciating the new tractor, a you agree to pay the dealer $15,500 cash for th new tractor if he will pay you $4,000 for your ol tractor. Since the two transactions are depend on each other, you are treated as if you exchanged your old tractor for the new one. Yo basis for the new tractor is $13,500, the same you traded the old tractor, and did not pay $15,500.

Involuntary Exchanges

If you acquire property as a result of an involu tary exchange, such as a casualty, theft, or con demnation, the basis of the replacement prope you acquire may be figured using the basis of property you exchanged.

Similar or related property. If you receive pr erty similar or related in service or use to the p erty exchanged, the basis of the new property the same as the basis of the old property on th date of the exchange with the following adjustments:

Decreased by:

a) Any loss recognized on the exchange,

b) Any money received that was not spen similar property.

Increased by:

a) Any gain recognized on the exchange,

b) Any cost of acquiring replacement pro erty.

Not similar or related property. If you rec money or other property not similar or related service or use to the old property, and you bu new property similar or related in service or u the old property, the basis of the new propert the cost of the new property decreased by th amount of gain not recognized on the exchan

For more information on involuntary excha see Chapter 13.

perty Received a Gift

jure the basis of property you receive as a ou must know its adjusted basis to the donor efore it was given to you, its fair market value) at the time it was given to you, and the int of gift tax paid on it.

less than donor's adjusted basis. If the of the property was less than the donor's sted basis, your basis for depreciation, deple- and amortization and for gain on its sale or r disposition is the same as the donor's sted basis.

ur basis for loss on the sale or other disposi- of property received as a gift is its FMV at the you received the gift. If you use the donor's sted basis for figuring a gain and compute a , and then use the FMV basis for figuring a and compute a gain, you will have neither a nor a loss on its sale or other disposition.

/ more than donor's adjusted basis. If the / of the property was equal to or greater than donor's adjusted basis, your basis for depreci- n, depletion, and amortization and for gain or on its sale or other disposition is the donor's isted basis at the time you received the gift. r basis is increased by all or part of the gift tax l, depending on the date of the gift.

ift received before 1977. If you received a before 1977, your basis in the gift (the donor's sted basis) is increased by the total gift tax l on it, but not above the FMV of the gift when as given to you.

xample 1. You were given a house in 1976. hat time, it had a FMV of $21,000 and the or's adjusted basis was $20,000. The donor d a gift tax of $500. Your basis for gain or loss l for depreciation is $20,500, the donor's usted basis plus the amount of gift tax paid.

xample 2. If, in Example 1, the gift tax paid l been $1,500, your basis would be $21,000. s is the donor's adjusted basis plus the gift tax d, limited to the FMV of the house at the time received the gift.

Gift received after 1976. If you received a gift er 1976, your basis in the gift (the donor's usted basis) is increased by the part of the gift paid that is due to the net increase in value of gift. This part is figured by multiplying the gift paid on the gift by a fraction. The numerator p part) of the fraction is the net increase in ue of the gift and the denominator (bottom part) the amount of the gift. The net increase in value the gift is the FMV of the gift less the donor's justed basis.

Example. In 1990, you received a gift of prop- ty from your mother. At that time, the property d a FMV of $50,000 and her adjusted basis was 0,000. She paid a gift tax of $9,000 on the prop- ty. For figuring depreciation, depletion, amortiza- n, and gain or loss, your basis is $25,400, which figured as follows:

r market value	$50,000
nus: Adjusted basis	20,000
t increase in value	$30,000
ft tax paid	$ 9,000
ultiplied by ($30,000 ÷ $50,000)	.60
ft tax due to net increase in value	$ 5,400
justed basis of property to your mother	20,000
ur basis in the property	$25,400

roperty Transferred rom a Spouse

he basis of property transferred to you or trans- rred in trust for your benefit by your spouse, or by your former spouse if the transfer is incident to divorce, is the same as the transferor's adjusted basis of the property. However, your basis is adjusted for any gain recognized by the transferor on a transfer of property in trust in which the sum of the liabilities assumed, plus the liabilities to which the property is subject, is more than the adjusted basis of the property transferred.

The transferor must supply you with records necessary to determine the adjusted basis and holding period of the property as of the date of the transfer.

For more information on the transfer of property between spouses, see Publication 551, *Basis of Assets*, and Publication 504, *Tax Information for Divorced or Separated Individuals.*

Inherited Property

Your basis in property you inherit is usually its fair market value at the date of the decedent's death. If a federal estate tax return has to be filed, your basis in property you inherit can be its fair market value at the alternate valuation date if the estate qualifies and elects to use alternate valuation, or the special-use valuation for real property used in farming or other closely held business, if elected by the estate. If a federal estate tax return does not have to be filed, your basis in the property is its appraised value at the date of death for state inheritance or transmission taxes.

Special farm real property valuation. Your basis in inherited property may also be figured under the special farm real property valuation method, if elected for estate tax purposes. When a person dies and certain conditions are met, the executor or personal representative of that person's estate may elect to value the qualified real property on the basis of its use as a farm, rather than on its fair market value. If this method of valuation is used for estate tax purposes, this value is used as the basis of the property for the heirs. The qualified heirs should be able to get the necessary value from the executor or personal representative of the estate.

If you are a qualified heir who received special-use valuation property, your basis in the property is the estate's or trust's basis in that property immediately before the distribution, increased by the amount of gain recognized by the estate or trust because of post-death appreciation. Post-death appreciation is the difference between the fair market value of the property on the date of distribution and the fair market value of the property either on the date of the individual's death or on the alternate valuation date. All fair market values are figured without regard to the special use valuation.

Your basis in special-use valuation property received from the estate of a decedent who died after 1981 may be increased if it becomes subject to the additional estate tax. This tax is assessed if, within 10 years after the death of the decedent, you dispose of the property to a nonfarm member or the property ceases to be used as a farm. To increase your basis in the property, you must make an irrevocable election and pay the interest on the additional estate tax figured from the date 9 months after the decedent's death until the due date for paying the additional estate tax. If you meet these requirements, your basis in the property is increased to its fair market value on the date of the decedent's death or the alternate valuation date. The increase in your basis is considered to have occurred immediately before the event that results in the additional estate tax.

You make the election by filing with Form 706-A, *United States Additional Estate Tax Return*, a statement that:

1) Contains your name, address, and taxpayer identification number,
2) Contains the name of the estate and its address and taxpayer identification number,
3) Identifies the election as an election under section 1016(c) of the Internal Revenue Code, and
4) Specifies the specific property for which the election is made,

See Publication 448, *Federal Estate and Gift Taxes*, for more information on valuation methods for estate tax purposes.

Community property. In community property states (Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin), husband and wife are each usually considered to own half the community property. When either spouse dies, the total value of the community property generally becomes the basis of the entire property, even the portion belonging to the surviving spouse. For this to apply, at least half of the community property interest must be includable in the decedent's gross estate, whether or not the estate must file a return.

For example, if at least half the fair market value of the community interest is includable in the decedent's estate and the fair market value of the community interest is $100,000, the basis of the surviving spouse's half of the property is $50,000 and the basis of the other half to the decedent's heirs is also $50,000.

For more information on the basis of inherited property, see Publication 551 and Publication 559.

8. Depreciation, Depletion, and Amortization

If you buy farm property, such as machinery, equipment, or structures, that has a useful life of more than a year, you generally cannot deduct its entire cost in one year. Instead, you must spread the cost over more than one year and deduct a part of it each year. For most types of property, this is called "depreciation."

The discussion in this chapter gives you basic information on the section 179 deduction and the modified accelerated cost recovery system (MACRS) that apply to property placed in service after 1986. It does not discuss the depreciation methods that apply to property placed in service before 1987. The percentage tables for property you are depreciating using ACRS are included for your convenience.

If you need more information, see Publication 534, *Depreciation.*

You are allowed a deduction for depletion for certain exhaustible natural resources and timber. You are also allowed as an amortization deduction each year a part of certain capital expenditures. Depletion and amortization are discussed later in this chapter.

It is important to keep good records for property you depreciate. Records of depreciable property and of depreciation allowed do not have to be complicated. In fact, simple ones often prove to be the best for income tax purposes. You claim depreciation, including the section 179 deduction, on Form 4562, *Depreciation and Amortization.* Keep your own records to verify the accuracy of the information on Form 4562. See the sample depreciation record and filled-in Form 4562 shown in Chapter 19.

What Can Be Depreciated

Property is depreciable if it meets all three of these tests.

1) It must be used in business or held for the production of income (for example, to earn rent or royalty income).
2) It must have a determinable life and that life must be longer than one year. The life of a piece of property is an estimate of how long you can expect to use it in your business or to earn rent or royalty income.
3) It must be something that wears out, decays, gets used up, becomes obsolete, or loses value from natural causes.

Depreciable property may be ***tangible*** or ***intangible***. Tangible property is any property that can be seen or touched. Intangible property is property, such as a copyright or franchise, that is not tangible. Depreciable property may be ***real*** or ***personal***. Personal property is property, such as machinery or equipment, that is not real estate. Real property is land and generally anything that is erected on, growing on, or attached to land. However, ***land itself is never depreciable***.

Livestock. Livestock acquired for work, breeding, or dairy purposes that is not kept in an inventory account may be depreciated.

Raised livestock. Livestock that you raise usually has no depreciable basis because the costs of raising it are deducted and are not added to the basis. See *Uniform Capitalization Rules*, in Chapter 7.

Logging truck roads. Logging truck roads that have a determinable useful life are depreciable.

Example 1. You construct a logging truck road on land you own for use in your timber operations. The road is expected to be used in your timber operations for an indefinite period. Past experience with similar roads indicates that the road surface will have to be replaced in 7 years and the bridges and culverts will have to be replaced in 20 years. The roadbed is not expected to need replacement. The surfacing, bridges, and culverts have determinable useful lives; therefore, they are depreciable. The roadbed does not have a determinable useful life; therefore, it is not depreciable.

Example 2. You construct a logging truck road on land you own to harvest a certain stand of timber. It is reasonable to expect that the harvesting of the timber will take 4 years. After the harvesting has been competed, the cutover land will be reforested and the road abandoned. All parts of the road have determinable useful lives to you. The useful life of the road ends upon completion of the timber harvesting and reforestation. The roadbed, as well as the surfacing, bridges, and culverts are depreciable.

Partial business use. If you use property both for business and personal purposes, you can only depreciate the business part. If you use your car for farm business, you can depreciate the car for the percentage of time you use it in farming. If you use part of your home for business, you may be able to take a depreciation deduction for this use. See Chapter 5.

Depreciation not deducted in an earlier year. If, in an earlier year, you did not claim depreciation you were entitled to deduct, you must still reduce your basis in the property by the amount of the depreciation you did not deduct. You may not deduct the ***unclaimed depreciation*** in the current year or any later tax year. However, you may claim the depreciation on an amended return (Form 1040X) for the earlier year. An amended return must be filed within 3 years from the date you filed your original return, or within 2 years from the time you paid your tax, whichever is later. A return filed early is considered filed on the due date.

Section 179 Deduction

You may elect to treat all or part of the cost of certain qualifying property as an expense rather than a capital expenditure. You must decide for each item of qualifying property whether to deduct, subject to the yearly limit, or capitalize and depreciate its cost. If you make the election for a deduction, a limited amount of the cost of qualifying property you buy for use in your trade or business is deductible in the first year you place the property in service. "Placed in service" is defined later under *Figuring Depreciation*.

Deduction limit. The total cost you may elect to deduct in 1990 may not exceed $10,000. The $10,000 maximum applies to each taxpayer and not to each business operated by a taxpayer.

While the maximum dollar amount that may be deducted is $10,000, there are certain provisions that can reduce this maximum.

Investment limit. For each dollar of cost of section 179 property placed in service in excess of $200,000 in a tax year, the $10,000 maximum is reduced (but not below zero) by one dollar.

Example. In 1990, James Smith placed in service machinery with a cost of $207,000. Since the cost of the machinery exceeds $200,000 by $7,000, he must reduce the maximum deduction allowed ($10,000) by $7,000. James is therefore entitled to a section 179 deduction for 1990 of $3,000.

Taxable income limit. The total cost that may be deducted in each tax year is limited to the taxable income from the active conduct of any trade or business during the tax year. Taxable income is figured as usual but without a deduction for the cost of any section 179 property and the deduction for half the self-employment tax. You cannot use a section 179 deduction to increase or create a net operating loss.

Any cost that is not deductible in one tax year under section 179 because of this limit may be carried to the next tax year and added to the cost of qualifying property placed in service in that tax year.

Example. Joyce Jones places in service in 1990 a machine that cost $8,000. The taxable income from her business for 1990 (determined without the cost of the machine and the deduction for half the self-employment tax) is $6,000. Her section 179 deduction is limited to $6,000. The $2,000 cost that is not allowed because of the taxable income limit can be carried to 1991.

See *Carryover of unallowable deduction* in Publication 534 for information on figuring the carryover.

Married taxpayers filing separate returns. A husband and wife filing separate returns for a tax year are treated as one taxpayer for the $10,000 maximum and for the $200,000 investment limit. Unless they elect otherwise, 50% of the cost of section 179 property, before the taxable income limit is applied, will be allocated to each.

Passenger automobiles. For passenger automobiles placed in service in 1990, your total section 179 deduction and depreciation cannot exceed $2,660 for 1990. See *Farm vehicles*, later, for the limits applicable to passenger automobiles placed in service before 1990.

Cost. The cost of property for the section 179 deduction does not include any part of the basis of the property determined by reference to the basis of other property held at any time by the person acquiring the property. For example, if you buy a new truck to use in your business, your cost for the section 179 deduction does not include the adjusted basis of the truck you trade in on the vehicle.

Partial business use. When you use propert both business and nonbusiness, you are eligi elect the section 179 deduction only if more th 50% of the property's use in the tax year the p erty is placed in service is for trade or busines purposes. You must allocate the cost of the pr erty to reflect only the business use of the prop erty. This is done by multiplying the cost of the property by the percentage of business use. U this adjusted cost to figure your section 179 deduction.

Election. You must make an election to take section 179 deduction. You make this election only in the first tax year the property is placed service.

Use Form 4562 to make your election and report your section 179 deduction. Make this tion by taking the deduction on Form 4562 file with your original tax return.

The election cannot be made on an amende tax return filed after the due date (including extensions), and once made, the election can be revoked with the consent of the Internal Re nue Service (IRS).

Qualifying property. You may claim the sec 179 deduction on depreciable property that is "section 38 property" and that is purchased fo use in the active conduct of your trade or business. You cannot take depreciation to the exte that you elect to expense the property cost.

The following property does not qualify for th section 179 deduction: (1) property acquired by one member from another component member the same controlled group, (2) property whose basis is determined by reference to the adjuste basis of the person from whom acquired or whi is acquired from a decedent, or (3) property you acquire from a related person if your relationshi to the related person would result in the disallo ance of losses.

Section 38 property. This includes proper used in a trade or business with a useful life of years or more for which depreciation or amorti tion is allowable and that is:

1) Tangible personal property (not including building and its structural components and including an air conditioning or heating uni
2) Elevators or escalators you build or acquir new,
3) Other tangible property, including certain property, used as an integral part of manu turing, production, or extraction, or used as research or bulk storage facility for fungibl commodities for these activities,
4) Livestock, other than horses, as long as yo do not sell or dispose of substantially iden livestock during the 1–year period beginni months before the date you got the livesto
5) Single purpose agriculture or horticultural structures (defined later), or
6) Rehabilitation expenditures for qualified buildings.

Single purpose structures. A ***single pur agriculture structure*** is any enclosure or structure specifically designed, constructed, used for:

1) Housing, raising, and feeding a particular of livestock (including poultry but not hor and its produce, and
2) Housing the equipment, including any replacements, necessary for the housing, raising, and feeding of this livestock.

A ***single purpose horticultural structure*** is:

1) A greenhouse specifically designed, constructed, and used for the commercial pro tion of plants, or

A structure specifically designed, constructed, and used for the commercial production of mushrooms.

r more information, see *Qualifying Property* in rt I of Publication 534.

guring the deduction. For 1990, the maximum ction 179 deduction is $10,000 of the cost of operty you purchase for use in your trade or siness. You decide how much of the cost of operty you want to deduct under section 179. u do not have to claim the full $10,000. Any st not deducted under section 179 may be preciated.

f you have more than one item of property, you n allocate the deduction between the items. If u have only one item of qualifying property and t item costs less than $10,000, such as $3,200, r deduction is limited to $3,200.

Subtract the amount you elect to deduct from basis of the qualifying property. Use this usted basis to compute your depreciation duction.

Example. In 1990, you bought a tractor for 6,000 and a mower for $6,200 for use in your ming business. Both items are placed in service 1990. You elect to deduct the entire $6,200 for mower and $3,800 for the tractor, a total of 0,000. This is the most you can deduct in 1990. ur $6,200 deduction for the mower has mpletely recovered the cost of that item. The st of your tractor is adjusted by $3,800. Its basis depreciation is $12,200. This is figured by sub- cting the amount of your section 179 deduction, ,800, from the cost of the tractor, $16,000.

capture of section 179 deduction. If you ducted the cost of qualifying property placed in vice ***after 1986*** and the property is not used re than 50% in a trade or business for any tax r before the end of the property's recovery riod, you must include in income the benefit you from the deduction.

Report any recapture of the section 179 deduc- n on Form 4797, *Sales of Business Property.*

Figure the amount to be included in income by tracting from your section 179 deduction the preciation that would have been allowable on section 179 amount for prior tax years and the year of recapture.

Example. Paul Lamb, a calendar year tax- ver, bought and placed in service on December 1988, an item of 3–year property costing 0,000. The property is not listed property. He ed the property only for business in 1988 and 89. He elected a section 179 deduction of 000 for it. During 1990 he used the property % for business and 60% for personal use. Had not elected to expense $5,000 in 1988, he uld have been entitled to deduct $1,666.50 .33% of $5,000) in 1988 and $2,222.50 .45% of $5,000) in 1989. In 1990 he would ve been entitled to deduct 40% of $740.50 .81% of $5,000) or $296.20. Therefore, he st include in income for 1990 the excess of ,000 over $4,185.20 ($1,666.50 + $2,222.50 + 96.20) or $814.80.

positions. If you dispose of the property, the ount you deducted under section 179 is subject recapture as ordinary income. See Publication 4, *Sales and Other Dispositions of Assets.*

iguring epreciation

fore figuring depreciation deductions, you must ow:

What your basis in the property is,
When the property was placed in service, and
Which method of depreciation you use.

Basis. Basis is a measure of your investment in the property you own. When you depreciate property, a certain percentage of your basis in it is deducted each year.

For property that you buy, your original basis is usually its cost to you. For property that you acquire in some other way—such as by inheriting it, receiving it as a gift, building it yourself, or getting it in a tax-free exchange—you must figure your original basis in some other way.

While you own the property, various events may take place that will change your basis. Some events, such as additions or permanent improvements to the property, increase basis. Others, such as casualty losses and the section 179 deduction, decrease basis. See Chapter 7 for more information on how to figure basis.

Nonbusiness property changed to business use. When you change property that was not used for business to a business use, you must determine your basis in the property for figuring depreciation. This amount is determined as of the date of the change. It is the fair market value of the property on that date or your adjusted basis in the property on that date, whichever is less. Fair market value is defined in Chapter 12.

Placed in service. Property is considered placed in service when it is first ready and available for its specified use whether in a trade or business, the production of income, a tax-exempt activity, or a personal activity. However, depreciation applies only to property placed in service in a trade or business or in the production of income.

Example. A corn planter that is delivered to the farm ready to be used in December 1990 is considered placed in service in the 1990 calendar year even though it will not be used until the spring of 1991. If the planter comes unassembled in December 1990 and is put together in February 1991, it is not considered placed in service until the 1991 calendar year.

Trees and vines. If you acquire an orchard, grove, or vineyard and the trees or vines have not yet reached the income-producing stage, your depreciation will begin when they reach the income-producing stage.

Immature livestock. If you acquire immature livestock for draft, dairy, or breeding purposes, your depreciation will begin when it reaches maturity, that is, when it reaches the age when it can be worked, milked, or bred.

Dispositions. If you dispose of depreciable property at a profit, you may have to report, as ordinary income, all or part of the profit. See Chapter 11.

Abandonments. If it suddenly becomes necessary for you to prematurely discard or abandon an asset permanently from use in your business, you may claim a loss in the year it is abandoned. Your intent must be to discard the asset so that you will not use it again or retrieve it for sale, exchange, or other disposition. The loss is your unrecovered cost or other basis of the property abandoned. This does not apply to your inventories. The loss must be fully explained on your tax return. Nonuse of property does not constitute an abandonment.

Alternative minimum tax. If you use accelerated depreciation for real property or personal property you lease to others, you may have to attach Form 6251, *Alternative Minimum Tax—Individuals,* to your return. The alternative minimum tax applies to tax preference items. Accelerated depreciation, which is a tax preference item, is any method, including MACRS, that allows you to deduct more depreciation than you could deduct using the straight line method. For more information, see Chapter 14.

Listed property placed in service or leased after June 18, 1984. There are limits on the depreciation deductions you may claim on listed property placed in service after June 18, 1984. These limits apply if the property is not used more than 50% in a qualified business use during any tax year. If leased after June 18, 1984, limitations are imposed on lessees that are substantially equivalent to those imposed on owners.

Listed property. Listed property includes:

1) Any passenger automobile (defined later).
2) Any other transportation vehicle.
3) Any property of a type generally used for entertainment, recreation, or amusement.
4) Any computer and related peripheral equipment.
5) Any cellular telephone (or similar telecommunication equipment) placed in service or leased in a tax year beginning after 1989.

For these limits, the term "other transportation vehicle" includes trucks, buses, boats, airplanes, motorcycles, and other vehicles for transporting persons or goods. However, certain types of special purpose farm vehicles, such as tractors and combines, are excluded from the application of the limitations because they are suited only for use in the business of farming.

Farm vehicles. In addition to the rules discussed above for listed property, there is a dollar limit on the deduction you may claim each year for passenger automobiles. The maximum depreciation deduction that you may claim for a passenger automobile for 1990 is determined by when you placed it in service. The maximum deductions for 1990 are:

Date Placed in Service	1990 Maximum
After June 18, 1984	
Before January 1, 1985	$6,000
After December 31, 1984	
Before April 3, 1985	$6,200
After April 2, 1985	
Before January 1, 1987	$4,800
After July 31, 1986	
Before January 1, 1987	
if MACRS elected for automobile	$1,475
In 1987	$1,475
In 1988	$2,450
In 1989	$4,200

For passenger automobiles placed in service during 1990, the depreciation deduction, including the section 179 deduction, may not be more than $2,660 for 1990 (the first tax year of the recovery period). For 1991 and 1992 (second and third years), the depreciation deduction will be limited to $4,200 and $2,550, respectively. The maximum will be $1,475 in each succeeding tax year.

These limits are further reduced if your business use is less than 100%.

A ***passenger automobile*** is any four-wheeled vehicle, such as a van or pickup truck, manufactured primarily for use on public streets, roads, and highways and rated at 6,000 pounds or less of unloaded gross vehicle weight (gross vehicle weight for trucks and vans). It includes any part, component, or other item physically attached to the automobile or traditionally included in the purchase price of an automobile. For more information on passenger automobiles, see Publication 917, *Business Use of a Car.*

Modified Accelerated Cost Recovery System (MACRS)

The modified accelerated cost recovery system (MACRS) (also referred to as the "General Depreciation System" or "GDS") generally applies to all tangible property placed in service after 1986. However, you could have made a property-by-property election to use MACRS for property placed in service after July 31, 1986, and before January 1, 1987.

Property classes. Each item of property depreciated under MACRS is assigned to a property class. The property class of an item of property establishes the number of years over which the basis of the property is recovered. This period of time is called a recovery period.

Items in property classes. Under MACRS, tangible property that you place in service after 1986, or after July 31, 1986, if elected, falls into one of the following classes.

3–year property. This class includes tractor units for use over the road, breeding hogs, any race horse that is over 2 years old when placed in service, and any other horse that is over 12 years old when placed in service. This property is depreciated over 3 years.

5–year property. This class includes breeding sheep and goats, breeding and dairy cattle, trucks, computers and peripheral equipment, and office machinery (typewriters, calculators, etc.), and any automobile. This property is depreciated over 5 years.

7–year property. This class includes farm machinery, equipment, and fences, office furniture and fixtures (desks, files, etc.), breeding and work horses 12 years old or less when placed in service, and, if placed in service before 1989, any single purpose agricultural or horticultural structure. This class also includes any property that does not have a class life and that has not been designated by law as being in any other class. This property is depreciated over 7 years.

10–year property. This class includes any single purpose agriculture or horticulture structure and any tree or vine bearing fruits or nuts placed in service after 1988. This property is depreciated over 10 years.

15–year property. This class includes depreciable roads, canals, and nonfarm fences. This property is depreciated over 15 years.

20–year property. This class includes farm buildings. This property is depreciated over 20 years.

Nonresidential real property. This class includes any real property that is not residential rental property (defined next) and section 1250 property with a class life of 27.5 years or more. This property is depreciated over 31.5 years.

Residential rental property. This class includes any real property that is a rental building or structure (including mobile homes) for which 80% or more of the gross rental income for the tax year is rental income from dwelling units. If you occupy any part of the building or structure, the gross rental income includes the fair rental value of the part you occupy. This property is depreciated over 27.5 years.

The class lives and recovery periods for most assets are listed in the *Table of Class Lives and Recovery Periods* in Part II of Publication 534.

Computing MACRS deductions. You can determine your MACRS depreciation deduction in one of two ways. You can use the percentages discussed later. Or you can actually compute the deduction using the applicable depreciation method and convention over the recovery period. The deduction is the same under both methods.

Depreciation methods. You depreciate property placed in service after 1988 in a farming business over the recovery period using the 150% declining balance method and a half-year or mid-quarter convention (discussed later). You change to the straight line method for the first tax year for which that method, when applied to the adjusted basis at the beginning of such year, will yield a larger deduction. Always use the straight line method and a mid-month convention for nonresidential real and residential rental property.

For farm property placed in service before 1989 in the 3–, 5–, 7–, or 10–year class, you use the double (200%) declining balance method over 3, 5, 7, or 10 years and a half-year or mid-quarter convention. For property in the 15– or 20–year class, you use the 150% declining balance method over 15 or 20 years and a half-year or mid-quarter convention. You change to the straight line method for the first tax year for which that method, when applied to the adjusted basis at the beginning of such year, will yield a larger deduction.

Fruit or nut trees and vines. Trees and vines bearing fruit or nuts are depreciated under MACRS using the straight line method over the recovery period of 10 years.

Straight line election. Instead of using the declining balance method, you may elect to use the straight line method with a half-year or mid-quarter convention over the recovery period. The election to use the straight line method for one item in a property class applies to all property in that class placed in service in the tax year of the election.

The election is made by entering "S/L" in column (f) of Part II of Form 4562. The election must be made by the due date (including extensions) for the tax return for the tax year the property for which the election is made is placed in service. You must attach a statement which contains your name, address, and taxpayer identification number, and identifies the election by Code section (Code section 168(b)(5)) and the property items for which the election is made.

Once made, the election to use the straight line method over the recovery period cannot be changed (see also *Alternate MACRS Method*, later).

Declining balance method. To figure your MACRS deduction, first determine your declining balance rate of depreciation. This is determined by dividing the declining balance percentage (150%) by the recovery period. For example, for 3–year property, divide 1.50 by 3 to get .50 or 50%.

Multiply the adjusted basis of the property by the declining balance rate and apply the half-year convention to figure your depreciation for the first year. In the second year, first adjust your basis for the amount of depreciation allowable for the first year. Then multiply this adjusted basis by the same rate used in the first year.

Straight line method. To figure your MACRS deduction under the straight line method, a new depreciation rate is determined for each tax year in the recovery period. For any tax year, the straight line rate is determined by dividing the number 1 by the years remaining in the recovery period at the beginning of the tax year. The rate is applied to the unrecovered basis of the property. If the remaining recovery period at the beginning of the tax year is less than 1 year, the straight line rate for that tax year is 100%.

For example, the straight line method applied to property with a 5–year recovery period results in a straight line rate of 20% (1 divided by 5) for a full tax year. After applying the half-year convention, the first year rate is 10%. At the beginning of the second year, the remaining recovery period is 4.5 years as a result of the half-year convention. The straight line rate for the second year is 22.22% (1 divided by 4.5). This second year rate is applied to the cost or other basis of the property reduced by the depreciation taken in the first year.

Another way to compute straight line depreciation is to divide your depreciable basis by the number of years in the recovery period. This gives you the depreciation for a full year. Apply the applicable convention to get the deduction for the first year. The deduction for the second and later years of the recovery period is the amount determine for a full year.

Conventions. Use a half-year convention to f ure the deduction for property other than nonre dential real and residential rental property. Und a special rule, you may have to use a mid-quar convention. For nonresidential real and residen rental property, a mid-month convention is alw used.

Half-year convention. The half-year convention treats all property placed in service, disposed of, during a tax year as placed in se or disposed of, on the midpoint of that tax year.

Mid-quarter convention. If during any tax year the total depreciable bases of MACRS pro erty placed in service during the last 3 months that tax year exceed 40% of the total deprecia bases of all MACRS property placed in service during that tax year, use a mid-quarter conventi instead of a half-year convention. In determining the total bases of property, do not include the basis of:

Residential rental property,

Nonresidential real property, or

Property placed in service and disposed of in the same tax year.

Under a mid-quarter convention, treat all prope placed in service, or disposed of, during any qu ter of a tax year as placed in service, or dispos of, at the midpoint of the quarter.

To figure your MACRS deduction for propert subject to the mid-quarter convention, first figu your depreciation for the full tax year. Then mu ply by the following percentages for the quarte the tax year the property is placed in service.

Quarter of tax year	Percentage
First	87.5%
Second	62.5%
Third	37.5%
Fourth	12.5%

See Publication 534 for more information, including percentage tables based on the mid quarter convention.

Mid-month convention. Under a mid-mon convention, treat all property placed in servic disposed of, during any month as placed in service, or disposed of, on the midpoint of tha month.

Percentage tables. The percentage tables based on the depreciation method, recovery period, and convention. The percentages in t tables are applied to the unadjusted basis of property each year of the recovery period. ***U justed basis*** is the same amount you would to compute a gain on a sale not reduced for depreciation but reduced by the amount you erly amortize or by the amount you elect to d under section 179.

150% table. The following table has the centages for 3–, 5–, 7–, and 20–year propert percentages are based on the 150% declini balance method and a half-year convention change to the straight line method. See Publication 534 for complete tables, includin tables for the mid-quarter convention.

Year	3–Year	5–Year	7–Year
1	25%	15%	10.71%
2	37.5%	25.5%	19.13%
3	25%	17.85%	15.03%
4	12.5%	16.66%	12.25%
5		16.66%	12.25%
6		8.33%	12.25%
7			12.25%
8			6.13%

Example 1. You buy for $10,000 and pl service on August 10, 1990, an item of 7–y

roperty. You do not elect a section 179 deducon for this property. The unadjusted basis of the roperty is $10,000. You use the percentage ables to figure your deduction.

Multiply $10,000 by 10.71% to get your depreciion for 1990 of $1,071 for this item of 7–year roperty. For 1991, figure your depreciation eduction by multiplying $10,000 by 19.13% to et $1,913.

Example 2. You have a barn constructed on our farm at a cost of $20,000. You place the barn n service on June 1, 1990. The barn is 20–year roperty and you use the table percentages to figre your deduction. You use the calendar year as our tax year. Figure your depreciation for it by multiplying $20,000 (unadjusted basis) by 3.75% o get $750. Your 1991 depreciation will be .219% of $20,000, or $1,443.80.

Straight line table. The following table has the ercentages for 3–, 5–, 7–, and 20–year property. he percentages are based on the straight line ethod and a half-year convention. See ublication 534 for complete tables, including bles for the mid-quarter convention.

ear	3-Year	5-Year	7-Year	20-Year
1	16.67%	10%	7.14%	2.5%
2	33.33%	20%	14.29%	5%
3	33.33%	20%	14.29%	5%
4	16.67%	20%	14.28%	5%
5		20%	14.29%	5%
6		10%	14.28%	5%
7			14.29%	5%
8			7.14%	5%

200% table. The following table has the perentages for 3–, 5–, and 7–year property. The perentages are based on the 200% declining alance method and a half-year convention with a hange to the straight line method. See ublication 534 for complete tables, including bles for the mid-quarter convention.

ear	3-year	5-year	7-year
1	33.33%	20%	14.29%
2	44.45%	32%	24.49%
3	14.81%	19.2%	17.49%
4	7.41%	11.52%	12.49%
5		11.52%	8.93%
6		5.76%	8.92%
7			8.93%
8			4.46%

Alternate MACRS Method

If you choose, you may use the alternate MACRS method (also referred to as the "alternative depreciation system" or "ADS") for most property. Under this method figure depreciation using a straight line method. The recovery periods for property under the alternate MACRS method are as follows:

Property	Recovery Period
Nonresidential real and residential rental property	40 years
Automobiles and light duty trucks	5 years
Computers and peripheral equipment	5 years
Single purpose agricultural and horticultural structures	15 years
Any tree or vine bearing fruit or nuts	20 years
Farm machinery and equipment	10 years
Grain bins	10 years
Fences	10 years
Cotton ginning assets	12 years
Cattle, breeding or dairy	7 years
Horses, breeding or work	10 years
Hogs, breeding	3 years
Sheep and goats, breeding	5 years
Farm structures (other than single purpose)	25 years

The alternate MACRS recovery periods for most property are listed in the *Table of Class Lives and Recovery Periods* in Part II of Publication 534.

Election. You make the election to use the alternate MACRS method by entering the depreciation on line 15 of Part II of Form 4562. Attach a statement which contains your name, address, and taxpayer identification number, and identifies the election by Code section (Code section 168(g)(7)) and the property items for which the election is made.

The election of an alternate MACRS method for one item of property in a property class applies to all property in that class placed in service during the tax year of the election. However, the election applies on a property-by-property basis for nonresidential real and residential rental property.

The election to use an alternate MACRS method once made cannot be changed.

Excluded Property

You cannot use MACRS for certain property placed in service before 1987 (before August 1, 1986, if election made), that is transferred or converted from personal to business use after 1986 (after July 31, 1986, if election made). Property that does not come under MACRS must be depreciated under ACRS or one of the other methods of depreciation based on useful life, such as straight line or declining balance, discussed in Part III of Publication 534. In addition, you may elect to exclude certain property from the application of MACRS.

Election to exclude certain property. If you properly depreciate any of your property under a method of depreciation that is not based on a term of years, such as the unit-of-production method, you may elect to exclude that property from MACRS. To figure a depreciation deduction under the unit-of-production method divide the cost or other basis (less salvage) by the estimated number of units to be produced during the life of the asset. Apply the resulting amount to the units produced in a year to arrive at your depreciation for that year.

To make this election, report the depreciation for the property on line 17, Part III, Form 4562, for the tax year in which your property is placed in service. You must attach a statement which contains your name, address, and taxpayer identification number, and identifies the election by Code section (Code section 168(f)(1)) and the property items for which the election is made.

If you use the standard mileage rate for an automobile you buy and use for business after 1980, you are considered to have elected to exclude the automobile from MACRS and ACRS. See Publication 917 for a discussion of the standard mileage rate.

Property placed in service before 1987. These excluded property rules apply to both personal and real property. However, the rules for personal property are more restrictive. For purposes of these rules, neither real nor personal property is treated as owned before it is placed in service. Therefore, if you owned property in 1986 but do not place it in service until 1987, it is not treated as owned in 1986.

Personal property. You may not use MACRS for most personal property (section 1245 property) that you acquired after 1986 (after July 31, 1986, if MACRS was elected) if:

1) You or a party related to you owned or used the property in 1986,
2) The property was acquired from a person who owned it in 1986 and as part of the transaction the user of the property does not change,
3) You lease the property to a person (or a person related to this person) who owned or used the property in 1986, or
4) The property is acquired in a transaction in which the user of the property does not change and the property is not MACRS property in the hands of the person from whom it is so acquired due to (2) or (3).

Real property. For real property, other than nonresidential real property or residential rental property (real property with a class life of less than 27.5 years), placed in service after 1986 (after July 31, 1986, if MACRS was elected), you cannot use MACRS if:

1) You or a party related to you owned the property in 1986,
2) You lease the property back to the person (or a person related to this person) who owned the property in 1986, or
3) You acquire the property in a transaction in which some of your gain or loss is not recognized. MACRS applies only to the part of your basis in the acquired property that represents cash paid or unlike property given up. It does not apply to the substituted portion of the basis.

Related parties. For the preceding rules, a party related to you includes members of your immediate family (including your spouse, ancestors, and lineal descendants).

Special rule. The excluded property rules discussed above do not apply to any property if the allowable deduction for the property for the first tax year it is placed in service using ACRS is greater than the deduction under MACRS using the half-year convention.

For more information on related parties and other special rules, see Publication 534.

Accelerated Cost Recovery System (ACRS)

Most property that you placed in service after 1980 and before 1987 is recovery property. Recovery property is tangible property of a character subject to the allowance for depreciation. You figure your depreciation deductions for recovery property under ACRS, the accelerated cost recovery system. You must continue to figure your depreciation under ACRS for assets placed in service after 1980 and before 1987.

The following percentage tables apply to property you are depreciating under ACRS.

5-year property:	
1st year	15%
2nd year	22%
3rd through 5th year	21%

10-year property:	
1st year	8%
2nd year	14%
3rd year	12%
4th through 6th year	10%
7th through 10th year	9%

The tables for 15–, 18–, and 19–year real property are shown below.

For information on ACRS and other methods, see Part III of Publication 534.

Depletion

You may generally deduct a reasonable amount for depletion if you own an economic interest in mines; oil, gas, or geothermal wells; other natural deposits, such as gravel, sand, and topsoil; or standing timber.

Economic interest. You generally own an economic interest if you have the legal right to receive income from the sale of natural resources. You do not have an economic interest if you only have the right to buy or process the mineral deposits or the timber. You also do not have an economic interest if you are only entitled to receive compensation for extracting the mineral deposits or cutting the trees.

Figuring the deduction. You may figure depletion by either the cost method or the percentage method. You may not use the percentage method for standing timber.

Cost method. You may use this method to figure the depletion deduction for mines; oil, gas, and geothermal wells; and other natural resources, including timber.

To figure the deduction, first determine the total number of units that can be recovered. This number of recoverable units can be measured in tons, barrels, board feet, etc., and is determined using the existing methods for that industry.

To determine the depletion for each unit, divide your adjusted basis in the property by the estimated number of recoverable units. Multiply the depletion for each unit by the total number of units sold during the tax year. If you are a cash basis taxpayer, this is the number of units for which you are paid during the tax year.

Cost depletion on ground water of Ogallala Formation. Farmers who extract ground water from the Ogallala Formation for irrigation are allowed cost depletion. Cost depletion is allowed when it can be demonstrated that the ground water is being depleted and that the rate of recharge is so low that, once extracted, the ground water is lost to the taxpayer and immediately succeeding generations.

For tax years ending prior to December 13, 1982, those extracting ground water for irrigation farming from areas in the Ogallala Formation outside the Southern High Plains were not required to reduce their basis in ground water by cost depletion that was allowable but not claimed and allowed.

Timber depletion. You can take depletion on timber (including Christmas trees) only if you cut it yourself or have it cut for you and do not elect to treat the cutting as a sale or exchange (see *Timber* in Chapter 10). To figure timber depletion, multiply the depletion for each unit by the number of units of standing timber cut. However, you may only deduct depletion in the tax year that the pro ucts (such as logs, cordwood, and lumber) from the timber are sold. The number of units sold wi depend on your accounting method, discussed i Chapter 3. You should include the depletion tha you cannot deduct for that year in the closing inventory on those products. If you claim a dedu tion for depletion of timber, attach Form T, *Fore Industries Schedules*, to your income tax return.

Example. Sam Brown bought a farm that included standing timber. In 1990, Sam determined that the stand could produce 300,000 uni when cut. At that time, the adjusted basis of the standing timber was $1,800. Sam cut and sold 27,000 units in 1990. Sam did not elect to treat the cutting of the timber as a sale or exchange. Sam's depletion for each unit for 1990 is $.006 ($1,800 ÷ 300,000). His deduction for depletion i $162 (27,000 × $.006). If Sam had cut 27,000 units but only sold 20,000 units in 1990, his deple tion for each unit would remain at $.006. Howev his depletion deduction would be $120 for 1990 and he would include the balance of $42 (7,000 x $.006) in the closing inventory for 1990.

Percentage depletion. You may use this method to figure depletion on certain mines, we and other natural deposits. You may not use thi method for standing timber, soil, sod, dirt, or turf. To figure depletion using this method, multiply your gross income for the tax year from that pro erty by the depletion percentage for that type of property. Under this method, your depletion deduction cannot be more than 50% of your taxa ble income from that property, figured without the depletion deduction and any net operating loss deduction.

For more information, see Chapter 11 in Publication 535.

15–year Real Property (other than low-income housing)
(Placed in service after 1980 and before March 16, 1984)

Year	Month Placed in Service											
	1	2	3	4	5	6	7	8	9	10	11	12
6th	6%	6%	6%	6%	7%	7%	7%	7%	7%	7%	7%	7%
7th	6%	6%	6%	6%	6%	6%	6%	6%	6%	6%	6%	6%
8th	6%	6%	6%	6%	6%	6%	5%	6%	6%	6%	6%	6%
9th	6%	6%	6%	6%	5%	6%	5%	5%	5%	6%	6%	6%
10th	5%	6%	5%	6%	5%	5%	5%	5%	5%	5%	6%	5%
11–15	5%	5%	5%	5%	5%	5%	5%	5%	5%	5%	5%	5%
16th	—	—	1%	1%	2%	2%	3%	3%	4%	4%	4%	5%

18–year Real Property
(Placed in service after June 22, 1984, and before May 9, 1985)

Year	Month Placed in Service											
	1	2	3	4	5	6	7	8	9	10	11	12
6th	6%	6%	6%	6%	6%	6%	6%	6%	6%	6%	6%	6%
7th	5%	5%	5%	5%	6%	6%	6%	6%	6%	6%	6%	6%
8-12th	5%	5%	5%	5%	5%	5%	5%	5%	5%	5%	5%	5%
13th	4%	4%	4%	5%	4%	4%	5%	4%	4%	4%	5%	5%
14-17th	4%	4%	4%	4%	4%	4%	4%	4%	4%	4%	4%	4%
18th	4%	3%	4%	4%	4%	4%	4%	4%	4%	4%	4%	4%
19th	—	1%	1%	1%	2%	2%	2%	3%	3%	3%	3%	3.6%

19–year Real Property
(Placed in service after May 8, 1985, and before 1987)

Year	Month Placed in Service											
	1	2	3	4	5	6	7	8	9	10	11	12
5th	6.3%	6.3%	6.4%	6.4%	6.5%	6.5%	6.6%	6.6%	6.7%	6.8%	6.8%	6.9%
6th	5.7%	5.7%	5.8%	5.9%	5.9%	5.9%	6.0%	6.0%	6.1%	6.1%	6.2%	6.2%
7th	5.2%	5.2%	5.3%	5.3%	5.3%	5.4%	5.4%	5.5%	5.5%	5.6%	5.6%	5.6%
8th	4.7%	4.7%	4.8%	4.8%	4.8%	4.9%	4.9%	5.0%	5.0%	5.1%	5.1%	5.1%
9th	4.2%	4.3%	4.3%	4.4%	4.4%	4.5%	4.5%	4.5%	4.5%	4.6%	4.6%	4.7%
10-19th	4.2%	4.2%	4.2%	4.2%	4.2%	4.2%	4.2%	4.2%	4.2%	4.2%	4.2%	4.2%
20th	0.2%	0.5%	0.9%	1.2%	1.6%	1.9%	2.3%	2.6%	3.0%	3.3%	3.7%	4.0%

Note: Complete tables are in Publication 534.

Amortization

You may deduct each year, as amortization, a pa of certain capital expenses. Amortization lets you recover these expenses in a way that is like straight line depreciation. See Chapter 10 in Publication 535 for more information.

Reforestation expenses. You may elect to amortize the costs for forestation or reforestation of qualified timber property. Qualifying expenses that you have during your tax year are set up as an amortizable basis for the tax year and amortized over an 84–month period.

Limit. The largest amount of expenses that can be set up as amortizable basis in each tax year is $10,000 ($5,000 if you are married filing separate returns). There is no carryover of exce expenses. If reforestation costs exceed these limits in a tax year, the amount in excess of the limit must be capitalized.

Qualified property. Qualified timber property is a woodlot or other site in the United States which will contain trees in significant commercia quantities. The woodlot must be one acre or mo in size. You must hold the property for the planting, cultivation, caring for, and cutting of tre for sale or use in the commercial production of timber products. Shelter belts and ornamental trees are excluded.

Qualified expenses. Reforestation expenses are the direct costs of planting or natural or arti cial seeding. This includes site preparation, see seedlings, labor, tools, and depreciation. You include in these costs depreciation on equipment such as tractors, trucks, tree planters, and simila machines used in this planting and seeding. Re estation expenses do not include any costs that are currently deductible.

Your reforestation expenses do not include a expenses for which you have been reimbursed under any governmental reforestation cost-sha ram, unless you included this reimbursement ur gross income.

mortization deduction. If you choose to rtize your qualifying expenses, set up these enses as your amortizable basis. A mandatory -year convention is provided. You may take a uction for only a half of a full-year's deduction e year the reforestation costs were incurred. de your amortizable basis by 84 to determine deduction you may take for each month. Your uction for the first year and the eighth year is 6 months only.

states. The reforestation deduction is availa- to estates in the same manner as individuals. deduction is allocated between the income eficiaries and the fiduciary. A beneficiary will ude any amount so allocated as part of his or limit.

rusts. Trusts are not allowed this reforesta- deduction.

nvestment credit. If you have qualifying restation expenses, you may also qualify for investment credit. For more information, see apter 9.

Election. To make the election, you should ach Form 4562 and a statement to your tax urn for the year in which the costs are incurred. e statement should describe the expenses and vide the dates they were incurred.

Recapture. If you dispose of qualified timber perty within 10 years of the year in which the ortizable basis was created and you claimed ortization deductions, part or all of any gain on disposition may be recaptured as ordinary ome.

llution control facilities. You may elect to ortize the cost of a certified pollution control ility over a period of 60 months. If the useful life he facility is greater than 15 years, you must ke an adjustment by reducing the amortizable is of the facility.

A certified pollution control facility is depreciable perty that is a new, identifiable treatment facil- used for abating or controlling water or atmos- eric pollution or contamination by removing, ering, disposing of, storing, or preventing the ation or emission of pollutants, contaminants, stes, or heat, and that is appropriately certified the state and federal certifying authorities. amples of such a facility include septic tanks d manure control facilities.

Amortization. The amortization deduction plies to any new certified pollution control facil- used with a plant (or other property) that was in eration before 1976.

f it appears that all or part of the cost of a facil- will be recovered from its operations, such as ough sales of recovered wastes, the federal rtifying authority will certify to that effect, scribing the nature of the potential cost recov- . The basis of the facility that may be amortized st be reduced accordingly. For more informa- n, see section 169 of the Internal Revenue de and the regulations thereunder.

Example. In 1990, you purchase a new $7,500 anure control facility for use on your dairy farm. e farm has been in operation since you bought n 1975 and all of the dairy plant was in opera- n before that date. You have no intention of covering the cost of the facility through sale of e waste and a federal authority has so certified. Your manure control facility qualifies for amorti- tion. You may choose to amortize its cost over months. Otherwise, you can capitalize the cost d depreciate the facility.

art-up expenses. You can elect to amortize costs you incur in the start-up of your busi- ss. Your costs are amortized over a period of months or more. The period begins the month u start or acquire your business.

Start-up costs are those expenses relating to estigating a business, setting up a business, or acquiring a business. These costs are amortized only if they would normally be deductible expenses if paid or incurred to expand a similar existing business. For more information, see *Going Into Business* in Chapter 10 of Publication 535.

9. General Business Credit

If you need more information about the credits than you find in this chapter, see Form 3800, *General Business Credit.*

Regular investment credit. The regular investment credit has been repealed for property placed in service after 1985. However, there are two exceptions that may apply to farmers. The exceptions are for qualified timber property and for transition property.

Qualified timber property. The regular investment credit is available for up to $10,000 of the expenses you incur each year to forest or reforest property you hold for growing trees for sale or for use in the commercial production of timber products. These expenses must qualify for amortization. You can take the investment credit for reforestation expenses whether you choose to amortize them or add them to the basis of your property. For more information about these expenses, see *Amortization* in Chapter 8.

Transition property. Transition property is property you place in service after December 31, 1985, if on that date you had a binding, written contract for its acquisition, construction, or reconstruction. See the *Instructions for Form 3468* for more information.

Rehabilitation credit. The rehabilitation credit is an investment credit you can take for expenses that you incur for the rehabilitation of certain buildings. Rehabilitation includes renovation, restoration, or reconstruction. It does not include enlargement or new construction. The percentages of your expenses that you can take as a credit are 10% for buildings that were placed in service before 1936 and 20% for certified historic structures.

The following requirements must also be met.

1) The building must be substantially rehabilitated. This requirement is met if, during a 24-month period that you select and that ends with or within your tax year, your rehabilitation expenses are more than:
   a) $5,000 or
   b) Your adjusted basis in the building if this amount is larger.
2) The building must have been placed in service before the beginning of the rehabilitation. This requirement is met if the building was placed in service by any person at any time before the rehabilitation begins.
3) At least 75% of the external walls must be retained, with 50% or more kept in place as external walls. Also, at least 75% of the existing internal structural framework of the building must be retained in place. This does not apply to certified historic structures.

See Form 3468, *Investment Credit,* for more information.

Business energy credit. The business energy credit is available through September 30, 1990, for solar, geothermal, and ocean thermal property that was placed in service before October 1, 1990. The credit percentage for solar property is 10%; for geothermal property, 10%; and for ocean thermal property, 15%.

Basis adjustment. Generally, you must reduce the depreciable basis of assets on which you take an investment credit. See Form 3468 for more information.

How to take the investment credit. Use Form 3468 to figure your credit. This form is used alone if the only credit you have is an investment credit, you have no carryover credits from another tax year, and your credit is not from a passive activity. Otherwise, you must also use Form 3800.

Carrybacks and Carryovers

Even if you cannot take an investment credit for 1990, you may have credits from earlier years that you were unable to use, and you may be able to use them to reduce your 1990 tax. These unused credits from earlier years are carried to your current tax year as general business credit carryovers, and the rules for the general business credit, discussed later, apply.

Special refundable investment tax credit for 1987. If you are a farmer who had unused investment tax credit carryovers in 1987, you can make a special election to get a refund of part of the carryovers. If you failed to make the special election on your 1987 return, you can still claim the credit any time within 3 years by filing an amended return on Form 1040X, *Amended U.S. Individual Income Tax Return.* Show the amount of this special credit and write the letters "QFE" (qualified farmers' election) to the left of line 14 and include the amount with your estimated tax payments on line 14.

Under this provision, you can use up to $1,500 of the carryovers to get an actual cash benefit of one-half of the amount up to $750. That is, for each $2 of carryover, you can get up to $1 of refund. However, neither the portion used in 1987 nor the half given up can be used as part of your carryovers to tax years past 1987.

To qualify, you must have earned 50% or more of your gross income from farming in 1984 through 1986, and the credit carryover must have come from your farming business. This one-time refundable 1987 credit is limited to the smallest of:

1) $750,
2) Half of your investment credit carryovers, or
3) Your net tax liability for the carryback period.

Carryback period. The carryback period begins with the 15th tax year before the year in which the unused investment credit carryover originated and ends with the 1985 tax year. However, the carryback period cannot begin before 1962. ***The net tax liability*** for the carryback period is the sum of the regular income tax on your prior tax returns reduced by the total of any credits you were entitled to claim. Do not include credits relating to fuel taxes. Your regular tax does not include any minimum tax or self-employment tax.

General Business Credit

The general business credit consists of the following credits: investment credit, jobs credit, alcohol fuel credit, research credit, low-income housing credit, or a carryover of any eligible credit from another tax year.

Tax limit. There is a limit on how much general business credit you can take in any one tax year. If your credit is more than this limit, you can carry the difference to another tax year and subtract it from your income tax for that year. See *Rule for carrybacks and carryovers*, later.

Your general business credit is limited to your net income tax minus:

1) Your tentative minimum tax or
2) 25% of your income tax liability that is more than $25,000,

whichever is ***larger.***

Net income tax. Your net income tax is your income tax liability plus your alternative minimum tax. Your ***income tax liability*** is your regular tax liability minus certain credits.

Use Form 3800 to figure your general business credit. You must use Form 3800 if you have more than one of the credits listed earlier, if you have a carryover credit from another tax year, or if you have a credit from a passive activity. For information about passive activity credits, see Form 8582-CR, *Passive Activity Credit Limitations.*

You must determine your tentative minimum tax before you figure your general business credit. Figure your tentative minimum tax on Form 6251, *Alternative Minimum Tax—Individuals.*

Example. Your general business credit for the year is $30,000. Your net income tax is $27,500. Your tentative minimum tax, figured on Form 6251, is $18,487. The amount of general business credit you can take for the tax year is limited to $9,013. This is your net income tax, $27,500, minus the ***larger of*** your tentative minimum tax, $18,487, or 25% of your income tax liability that is more than $25,000 (25% of $2,500 = $625).

Married persons filing separate returns. If you are married and file a separate return, you must each figure your limit separately. In figuring your separate limit, use $12,500 instead of $25,000. However, if one spouse has no credit for the tax year and no carryovers or carrybacks of any credit to that year, the other spouse can use the full $25,000 instead of $12,500 in figuring the limit based on the separate tax.

Rule for carrybacks and carryovers. In general, you can carry the unused portion of your credit back to your last 3 tax years and use it to reduce your tax in those years. First, carry the unused portion to the earliest of your last 3 years. If you cannot use it all in that year, carry the remaining unused portion to the second earliest year and so on. Any unused credit that you could not take in these 3 earlier years can be carried forward in the same way to the next 15 tax years until it is used up.

Credits must be used in the order in which they are earned.

1) First, for any tax year, use your credit carryover (earliest year first).
2) Next, use the current year's credit.
3) Finally, use your credit carrybacks (earliest year first).

Unused carryover. If you have any unused credit carryover in the year following the end of the 15-year carryover period, you generally can deduct the unused amount. This deduction is limited to 50% of any unused investment credit. If an individual dies, or a corporation, trust, or estate ceases to exist, the deduction is allowed for the tax year in which the death or cessation occurs.

Refunds. A claim for refund based on your general business credit carryback to a prior tax year can be made by filing an amended return for the tax year to which you carry the unused credit. Use Form 1040X if your original return was a 1040. Attach Form 3800 to your amended return.

Generally, you must file the amended return for the carryback year no later than 3 years after the due date, including extensions, for filing the return for the year that resulted in the carryback.

Quick refunds. You can apply for a quick refund of an earlier year's taxes. For a quick refund, file Form 1045, *Application for Tentative Refund,* if you filed an individual income tax return. This form must be filed within 12 months after the end of the tax year in which you earn the credit.

Recapture of Investment Credit

At the end of each tax year, you must determine whether you disposed of or stopped using in your business (either partially or entirely) any property for which you claimed investment credit in a prior year. If you dispose of property before the end of the recapture period, you must recapture a percentage of the credit by adding it to your tax. See *Recapture Rule,* later, for a discussion of recapture period.

Form 4255, *Recapture of Investment Credit,* is used to figure the recapture tax. Or you may attach a detailed statement to your return for the year you dispose of the asset showing the computation of the recapture and the decrease in any investment credit carryover. Form 4255 is illustrated in Chapter 19.

Dispositions. An outright sale of property is the clearest example of a disposition. Another type of disposition occurs when you exchange or trade in worn-out or obsolete business assets for new ones. You also have a disposition of property for investment credit recapture purposes if the property ceases to be qualifying property. An example is when business property is converted to personal use or when a single purpose livestock or horticultural structure no longer qualifies as a single purpose structure.

Not every transaction results in a disposition for investment credit recapture purposes. The following are some examples of events that may or may not be dispositions.

Mortgaging and foreclosure. There is no disposition if title to property is transferred as security for a loan. However, a disposition does occur if there is a transfer of property by foreclosure.

Leased property. The leasing of investment credit property by the lessor who took the credit is generally not a disposition. However, if the lease is treated as a sale for income tax purposes, it is a disposition. A disposition also occurs if property ceases to be investment credit property in the hands of the lessor, the lessee, or any sublessee.

Decrease in basis. If the basis of investment credit property decreases, the amount of the decrease is considered to be a disposition. This occurs, for example, if you buy property and later receive a refund of part of the original purchase price. You must then refigure the credit as if the amount of the decrease in basis was never part of the original basis. If your refigured credit is less than the original credit you took, you must add the difference to your tax.

Retirement or abandonment. You dispose of property if you abandon or otherwise retire it from use. Normal retirements are also dispositions.

Transfer by reason of death. There is no disposition of investment credit property if the property is transferred because the owner-taxpayer died.

Gifts. Property transferred by gift is considered disposed of.

Transfers between spouses. If you transfer investment credit property to your spouse, or you transfer the property to your former spouse incident to a divorce, you generally are not considered to have disposed of the property. This also
applies if the transfer is made in trust for th
fit of the spouse or former spouse. Howeve
spouse or former spouse later transfers the
erty, the transfer will receive the same tax
treatment that would have applied to you if
had made the transfer.

Casualties and theft. Property destroye
casualty or lost by theft is treated as having
disposed of.

Change in form of doing business. A
sition does not occur because of a change i
form of doing business if certain conditions
met. For more information, see section 1.47
the Regulations.

Recapture Rule

If you dispose of property for which you cla
the investment credit before the end of the
recapture period (defined in the next paragr
you must recapture, as an additional tax, pa
the credit you claimed originally. You may a
have to recapture if you change the use of
investment credit property to a use that wou
have originally qualified for the credit.

The amount of credit that you must recap
depends upon when during the recapture p
you dispose of, or change the use of, the pr
The ***recapture period*** is the length of time
property must be used in order to get the fu
investment credit.

Use Form 4255 to figure the recapture an
The credit recapture is figured by multiplying
recapture percentage, from the tables in Fo
4255, by the original investment credit taken
result of this computation is the amount of t
recapture.

After you figure your recapture amount, re
your investment credit by subtracting the
recapture amount from the original credit. Y
must also refigure any unused credits carrie
or carried over to any other tax year that are
affected by the decrease in the credit allowe
because of the recapture. You may not have
add all of the recapture amount to your tax.

If the refigured credit is less than the cred
you actually took in the year the asset was
in service, and also for any carryback and
carryover years, you must add to your tax, f
year the asset is disposed of, the difference
between the original credit and the refigure
credit.

Example. In May 1986, you took deliver
two new machines which you had signed a
contract for in 1985 and which cost $6,000
$5,000. The machines were 5-year recover
erty. You placed each machine in service w
was delivered. You did not elect to take the
section 179 deduction for any part of the co
either machine. Your 1986 return showed a
investment credit of $1,100 against income
adjusted, of $1,500. In December 1990, you
the $6,000 machine.

Since you sold the machine in the fifth ye
service, you must recapture $120 (20% of
of the original investment credit. This decre
your original credit on the $6,000 machine
$480. You add the amount of the recapture
to your 1990 tax.

Net operating loss carrybacks. If you
net operating loss carryback from the recap
year or a later year that reduces your tax fo
recapture year or an earlier year, you may h
refigure your recapture. See section 1.47-1(
of the Regulations.

10. Gains and Losses

Important Changes for 1990

Like-kind exchanges. Restrictions have been added to the rules allowing a tax-free exchange of like-kind property. If related parties exchange like-kind property, they must wait 2 years before either can sell or dispose of the property exchanged.

New Form 8824. Beginning in 1990, if you exchange property in a like-kind transaction, you must file Form 8824, *Like-Kind Exchanges*, in addition to Schedule D (Form 1040) or Form 4797.

Everything you own is, for income tax purposes, either a capital asset or a noncapital asset. The capital gain and loss rules of the income tax law are of special interest to farmers. Under these rules, gains and losses from sales or other dispositions of noncapital assets used in the farming business and held more than one year, or longer in the case of livestock held for certain purposes, as explained later in this chapter, are often treated as sales of capital assets.

Because of the tax treatment of gain or loss, it is important for you to distinguish or classify your gains and losses as either capital or ordinary gains or losses and as either short-term or long-term gains or losses. These distinctions are essential in order to arrive at your net capital gain or loss and to separate such items from income that belong on Schedule F (Form 1040).

Single sale of assets. If you sell several assets in a single sale for a lump sum, you generally must allocate the selling price among all the assets sold according to the relative value of each asset. To figure your gains and losses, you must know the meaning of the terms "basis" and "adjusted basis," which are discussed in Chapter 7.

Capital Assets

For income tax purposes, all property you own and use for personal purposes, pleasure, or investment is a capital asset. An intangible property right may also be a capital asset.

Some examples of capital assets include:

A home. One that is owned and occupied by you and your family.

Household furnishings. Items used by you and your family.

An automobile. This is one that you used for pleasure. If your automobile is used both for pleasure and for farm business, it is partly a capital asset and partly a noncapital asset, defined later.

Stocks and bonds. Securities held by individuals for investment. Losses on certain small business stock, however, may be treated as losses on property that is not a capital asset. For more information on this subject, see *Losses on Small Business Investment Company Stock* in Publication 550, *Investment Income and Expenses.*

A commodity futures contract. One entered into for speculative purposes. Report gains and losses from sales of regulated futures contracts on Form 6781, *Gains and Losses From Section 1256 Contracts and Straddles.* See *Commodity Futures* in Publication 550. If you purchased the contract for protection against price fluctuations in commodities, it is an ordinary asset and income or loss is reported on Schedule F. See Chapter 5.

Quotas and allotments. Certain areas of the country have quotas or allotments for such commodities as ***milk, tobacco, etc.*** These are intangible property rights. Generally, they are not subject to amortization or depreciation. If you acquire a right to a quota with the purchase of land or with the purchase of a herd of dairy cows, you must allocate part of the purchase price to that right.

Short-term or long-term. A sale or exchange of a capital asset usually will result in either a short-term or a long-term capital gain or loss, depending on the period of time the property is held.

If held one year or less, the gain or loss resulting from the sale or exchange is short term.

If held more than one year, the gain or loss resulting from the sale or exchange is long term.

Holding period. To figure if you held property more than one year, you begin counting on the day after the day you acquired the property. This same date of each following month is the beginning of a new month regardless of the number of days in the preceding month. Count the day you disposed of the property as part of your holding period.

Example. If you bought an asset on June 19, 1990, you should start counting on June 20, 1990. If you sell the asset on June 19, 1991, your holding period is not more than one year, but if you sell it on June 20, 1991, your holding period is more than one year.

Nontaxable exchanges. If you acquire an asset in exchange for another asset and your basis for the new asset is determined, in whole or in part, by your basis in the old property, the holding period of the new property includes the holding period of the old property. That is, it begins on the same day as your holding period for the old property.

Property received in an exchange or conversion. If you receive property in a like-kind exchange or involuntary conversion, the recomputed basis of that property includes a depreciation or amortization adjustment taken on the old property you exchanged or converted. This adjustment is reduced by any gain you recognized in the exchange or conversion of the old property.

Gifts. If you receive a gift of property, and your basis is figured using the donor's basis, the first day of your holding period is the same date the donor used to figure the holding period.

Real property. To figure how long you have held real property, start counting on the day after you received title to it, or, if earlier, on the day after you took delivery or possession and assumed the burdens and privileges of ownership.

However, taking delivery or possession of real property under an option agreement is not enough to start the holding period. The holding period of the seller cannot end before the date the option is exercised.

Inherited property. If you inherit property, your basis in that property is generally its fair market value at the date of the decedent's death or later alternate valuation date, if the estate qualifies and elects to use the alternate valuation. If no federal estate tax return was filed, use the appraised value (fair market value) at the date of death for State inheritance or transmission taxes. You cannot use an alternate valuation date.

Bad debt. A nonbusiness bad debt is always treated as a short-term capital loss. See the example on the filled-in Schedule D (Form 1040), *Capital Gains and Losses*, in Chapter 19.

Personal casualty gains and losses. To figure your personal casualty (or theft) loss, reduce each loss by $100. If your personal casualty gains for the tax year exceed your personal casualty losses, all of your personal casualty gains and losses are treated as sales or exchanges of capital assets. However, if your losses for the tax year exceed your gains, they are deductible on Schedule A to the extent they exceed 10% of your adjusted gross income. Use Section A of Form 4684, *Casualties and Thefts*, to report all personal casualty gains and losses. For more information, see *Figuring the Deduction* and *Form 4684* in Publication 547, *Nonbusiness Disasters, Casualties, and Thefts.*

How to determine gain or loss on sale. Whether short term or long term, the amount of a capital gain or loss from a sale is the difference between the amount realized and the adjusted basis of the property plus selling expenses. Your capital gains and losses are figured on Schedule D (illustrated in Chapter 19).

Net capital gain or loss. The totals for short-term capital gains and losses and the totals for long-term capital gains and losses must be figured separately.

You add your long-term capital gains and losses separately and subtract one total from the other to get your net long-term capital gain or loss. Then add your short-term capital gains and losses separately and subtract one total from the other to get your net short-term capital gain or loss.

Treatment of capital losses. If you have a net capital loss, you must deduct it even if you do not have ordinary income to offset the loss. The yearly limit on the amount of the capital loss you are required to deduct is the lower of:

- $3,000 ($1,500 if you are married and file a separate return), or
- Your net capital loss on line 18 of Schedule D (Form 1040).

Noncapital Assets

An asset is a noncapital asset if it is not a capital asset. A list of properties that are not capital assets is in the Schedule D Instructions.

Property held for sale in the ordinary course of your farm business. Property you hold mainly for sale to customers such as livestock, poultry, livestock products, and crops, are noncapital assets. Gain or loss from sales or other dispositions of this property is reported on Schedule F (not on Schedule D or Form 4797, *Sales of Business Property*).

Land and depreciable properties. Noncapital assets include land and depreciable properties you use in farming. However, as explained in Chapter 11 under *Section 1231 property*, your gains and losses from sales and exchanges of your farmland and depreciable properties must be considered together with certain other transactions to determine whether the gains and losses are treated as capital or ordinary gains and losses.

Nontaxable Exchanges

Certain exchanges are nontaxable. This means that any gain from the exchange is not taxed, and any loss cannot be deducted. In other words, even though you may ***realize*** a gain or loss on the exchange, it will not be ***recognized*** (included in income) for tax purposes until you sell or dispose of the property you receive.

There are strict limits on nontaxable exchanges. These limits are described in the following paragraphs.

Property exchanged must be held for business use or investment. You must hold the property you exchange for productive use in a trade or business, such as the farming business, or for investment. The exchange must be for property to be held for the same purpose. For example, a farm truck traded for another farm truck qualifies under this provision, but a farm truck traded for a family car that is not used in the farm business does not qualify.

The basis of property acquired in an exchange is explained under *Other Basis* in Chapter 7.

Property exchanged must be for property of a like kind. "Like kind" refers to the nature or character of the property, not to its quality or grade. A trade of a truck for a tractor is an exchange of like-kind property, and so is a trade of timberland for crop acreage. A trade of a tractor for an acreage, however, is not an exchange of like-kind property. Neither is the trade of livestock of one sex for livestock of the other sex. You have made a like-kind exchange if you trade your farm for another farm or if you trade your farm for city property or if you trade improved property for unimproved property.

Partially nontaxable exchange. If you trade your property for like-kind property and also receive money or unlike property in the exchange, gain on the exchange is taxable to the extent of the money and the fair market value of the unlike property received. A loss is not deductible.

Example 1. You trade farmland that cost you $3,000 for $1,000 cash and other land to be used in farming with a fair market value of $5,000. You have a gain of $3,000, but only $1,000, the money received, is taxable. If, instead of money, you received a tractor with a fair market value of $1,000, your taxable gain is limited to $1,000, the value of the tractor.

Example 2. Assume in Example 1 that the fair market value of the land you received was only $1,500. Your $500 loss is not deductible.

Money paid or unlike property given up. If you trade property for like-kind property and also pay money in the exchange, you have no taxable gain or deductible loss. The money is additional investment in the property acquired.

If you trade property for like-kind property and also give up unlike property in the exchange, you have a taxable gain or deductible loss only on the unlike property you give up. This gain or loss is the difference between the fair market value and the adjusted basis of the unlike property.

Property held primarily for sale. The nontaxable exchange rules do not apply to exchanges of property held primarily for sale. Exchanges of this property, such as crops or produce, result in taxable gains or losses.

Exchanges of stocks, bonds, or other securities. The nontaxable exchange rules generally do not apply to these exchanges. Therefore, they are generally taxable.

Receipt of title from third party. If you received property in a like-kind exchange and the other party who transfers property to you does not give you the title but a third party does, you may still treat this transaction as a nontaxable exchange.

Like-kind exchanges between related parties. New rules limit whether certain exchanges made between related parties after July 10, 1989, are nontaxable. These rules affect both direct and indirect exchanges. As with other like-kind exchanges, when related parties exchange like-kind property, no gain or loss is recognized (included in income). Under the new rules, however, if either party disposes of the property within 2 years after the exchange, then the exchange is disqualified from nonrecognition treatment. The gain or loss must then be recognized as of the date of disposition of the property. The two year holding period begins on the date of the last transfer of property which was part of the like-kind exchange.

Related parties. Under these rules, a related party includes a member of your family (spouse, brother, sister, parent, child, etc.) and a corporation in which you have more than 50% ownership. For more information on related parties, see *Loss not deductible*, under *Sales and Exchanges Between Related Parties* in Publication 544.

Exceptions to the related party rules. The following kinds of property dispositions are excluded from the new limits on nontaxable like-kind exchanges between related parties:

1) Dispositions due to the death of either related person,
2) Involuntary conversions, or
3) Exchanges or dispositions if it is established to the satisfaction of the IRS that the main purpose is not the avoidance of federal income tax.

Reporting the exchange. Report the exchange of like-kind property on Schedule D or on Form 4797, whichever applies. The instructions for each form explain how to report the details of the exchange. Report the exchange even though no gain or loss is recognized.

New Form 8824. Beginning in 1990, if you exchange property in a like-kind transaction, you must file Form 8824, *Like-Kind Exchanges* in addition to Schedule D (Form 1040) or Form 4797.

For more information on like-kind exchanges, see *Like-Kind Exchanges* in Publication 544.

Transfers between spouses. No gain or loss is recognized (included in income) on a transfer of property from an individual to (or in trust for the benefit of) a spouse, or to a former spouse if incident to divorce. This rule does not apply if the transferee spouse is a nonresident alien. Nor does it apply to a transfer in trust if the adjusted basis of the property is less than the amount of the liabilities assumed and liabilities on the property.

For more information, see *No gain or loss* under *Property Settlements* in Publication 504, *Tax Information for Divorced or Separated Individuals.*

Livestock

If livestock is held for more than 1 year (more than 2 years for horses, or cattle) and used in your trade or business, you include the gain or loss from its disposition on Form 4797 as indicated on the chart in Chapter 11. Gain or loss on livestock held primarily for sale is not included on Form 4797, but is reported on Schedule F as ordinary income or loss.

Livestock. Livestock includes, for purposes of section 1231 (see Chapter 11), cattle, hogs, horses, mules, donkeys, sheep, goats, fur-bearing animals (such as mink), and other mammals. It does not include chickens, turkeys, pigeons, geese, other birds, fish, frogs, reptiles, etc. For purposes of section 1245 (see *Depreciation Recapture on Personal Property* in Chapter 11), it includes horses, cattle, hogs, sheep, goats, mink, and other fur-bearing animals.

Livestock used in trade or business. If livestock is held primarily for draft, breeding, dairy, or sporting purposes, it is used in your trade or business. The purpose for which an animal is held ordinarily is determined by a farmer's actual use of the animal. An animal is not held for draft, breeding, dairy, or sporting purposes merely because it is suitable for that purpose, or because it is held for sale to other persons for use by them for that purpose.

Example 1. You discover an animal you to use for breeding purposes is sterile. You dispose of it within a reasonable time. This was held for breeding purposes.

Example 2. You retire and sell your entire herd, including young animals you would have used for breeding or dairy purposes had you remained in business. These young animals held for breeding or dairy purposes. In addition you sell young animals to reduce your breeding dairy herd because of, for example, drought, animals are treated as having been held for breeding or dairy purposes.

Example 3. You are in the business of hogs for slaughter. Customarily, before selling your sows, you obtain a single litter of pigs raise for sale. You sell the brood sows after obtaining the litter. Even though you hold the brood sows for ultimate sale to customers in ordinary course of your business, they are co ered to be held for breeding purposes.

Example 4. You are in the business of registered cattle for sale to others for use as breeding cattle. It is the business practice to the cattle before sale to establish their fitness registered breeding cattle. Your use of the you cattle for breeding purposes is ordinary and ne essary for selling them as registered breeding cattle. Such use does not demonstrate that you are holding the cattle for breeding purposes. H ever, those cattle held by you as additions or replacements to your own breeding herd to pro duce calves that you add to your herd are con ered to be held for breeding purposes even though they may not actually have produced calves. The same applies to hog and sheep breeders.

Example 5. You are in the business of breeding and raising mink that you pelt for the trade. You take breeders from the herd when are no longer useful as breeders and pelt them. Although these breeders are processed and pelted, they are still considered to be held for breeding purposes. The same applies to bree of other fur-bearing animals.

Example 6. You breed, raise, and train ho for racing purposes. Every year you cull some ses from your racing stable. In 1990 you decid that to prevent your racing stable from getting large to be effectively operated, you must cull horses from it. All six of these horses had been raced at public tracks in 1989. These horses all considered held for sporting purposes.

Figuring gain or loss on the cash method. Farmers or ranchers who file their income tax returns on the cash method figure their gain or loss on the sale of livestock held for draft, breeding, dairy, or sporting purposes as follow

Raised livestock. The gross sale price reduced by any expenses of sale is gain. Expenses of sale include sales commissions, freight or hauling from farm to commission com pany, and other similar expenses. The basis of animal sold is zero if the costs of raising it were deducted during the years the animal was bein raised. However, see the *Uniform Capitalizatio Rules* in Chapter 7.

Purchased livestock. The gross sales pri less your adjusted basis and any expenses of gives you the gain or loss.

Example. A farmer sold a breeding cow on January 4, 1990, for $1,250. Expenses of sale were $125. The cow was bought July 2, 1987, $1,300. Depreciation (not less than the amou allowable) was $754.

Gross sales price		$1
Cost (basis)	$1,300	
Less: Depreciation deduction	754	
Unrecovered cost (adjusted basis)	$ 546	
Expense of sale	125	
Gain realized		$

Converted Wetland and Highly Erodible Cropland

Any gain realized on the disposition of converted wetland or highly erodible cropland is treated as ordinary income. Any loss on the disposition of such property is treated as a long-term capital oss. This rule is effective for dispositions of land converted to farming use after March 1, 1986, in ax years ending after that date.

Converted wetland. This is generally land that must have been drained or filled to make the production of agricultural commodities possible. It ncludes land held by the person who originally converted the wetland or by any other person who used the land at any time after conversion for arming purposes.

Highly erodible cropland. This is cropland that has eroded that you used at any time for farming purposes other than for the grazing of animals. Generally, highly erodible cropland is land that is currently classified by the Department of Agriculure as class IV, VI, VII, or VIII land under its classification system, or that would have an excessive average annual erosion rate in relation to the soil loss tolerance level, as determined by the Department of Agriculture.

Successors. Converted wetland or highly erodble cropland is also land held by any person, whose basis in the land is figured by reference to he adjusted basis of a person in whose hands the property was converted wetland or highly erodible cropland.

Timber

f you sell standing timber you held as investment property, it is a capital asset and is treated as a sale of a capital asset. Gain or loss is reported on Schedule D. If you held the timber primarily for sale to customers, it is not a capital asset. Gain or loss on its sale is ordinary income or loss. It is reported in the gross receipts/sales and cost of goods sold items of your return. Special rules apply if you owned the timber more than one year and you either choose to treat timber cutting as a sale or exchange, or enter into a cutting contract discussed below. Depletion on timber is discussed under *Depletion* in Chapter 8.

Usually, farmers who cut timber on their land and sell it as logs, firewood, or pulpwood have no cost or other basis for that timber. These sales constitute a very minor part of their farm business. n these cases, amounts realized from such sales, and the expenses incurred in cutting, hauling, etc., may be entered as ordinary farm income and xpenses on Schadule F.

Timber considered cut. Timber is considered cut on the date when in the ordinary course of business the quantity of felled timber is first definitely determined. This is true whether the timber s cut under contract or whether you cut it yourself.

Christmas trees. Evergreen trees, such as Christmas trees, that are more than 6 years old when severed from their roots and sold for ornamental purposes, are included in the term "timber." They qualify for the rules, discussed below.

Timber cutting treated as a sale or exchange. Under the general rule, the cutting of timber results in no gain or loss. It is not until the sale or xchange that gain or loss is realized. But if you owned timber, or had a contractual right to cut timber, you may choose to treat the cutting of timber s a sale or exchange in the year it is cut. Even hough the cut timber is not actually sold or xchanged, you report your gain or loss on the cutting for the year the timber is cut. Any later sale results in ordinary income or loss.

To qualify for this election, the timber must be cut for sale or for use in your trade or business, and you must have owned the timber or held a contractual right to cut the timber for a period of more than one year. If you make a valid election, your cut timber is treated as section 1231 property used in a trade or business regardless of whether the timber is inventoriable or held primarily for sale to customers.

Election. You make your election on your return for the year in which the cutting takes place by including in income the gain or loss on the cutting, and including a computation of your gain or loss. You do not have to make the election in the first year you cut the timber. You may choose to make it in any year to which the election would apply. If the timber is partnership property, the election is made on the partnership return. This election cannot be made on an amended return.

Once you have made the election, it remains in effect unless you can show undue hardship. Except for the special rule, below, you must obtain the consent of the IRS to revoke your election. A revocation prevents you from again making this election except with the consent of the IRS.

Revocation of election. A special rule for any election you made for a tax year beginning before 1987 allows you to revoke the election for any tax year ending after 1986 without the consent of IRS. You can revoke the election by attaching a statement to the tax return for the tax year that the election is to be effective. However, any further revocation or later election will require IRS consent.

Gain or loss. Your gain or loss on the cutting of standing timber is the difference between its adjusted basis for depletion and its fair market value on the first day of your tax year in which it is cut.

The adjusted basis for depletion of cut timber is based upon the number of units (feet board measure, log scale, or other units) of timber cut during the tax year that are considered to be sold or exchanged. The adjusted basis for depletion is also based upon the depletion unit of timber in the timber account used for the timber cut, and should be figured in the same manner as shown in IRC 611 and regulations 1.611-3.

Example. In April 1990, you have owned for more than 6 months 4,000 MBF (1,000 board feet) of standing timber. It has an adjusted basis for depletion of $40 per MBF. You are a calendar year taxpayer. On January 1, 1990, the timber had a fair market value of $120 per MBF. It was cut in April for sale. On your 1990 tax return, you elect to treat the cutting of the timber as a sale or exchange. You report as a gain the difference between the fair market value and your adjusted basis for depletion. This amount is reported on Form 4797, along with your other section 1231 gains and losses to figure whether it is treated as long-term capital gain or as an ordinary gain. You figure your gain as follows:

Fair market value of timber January 1, 1990 ..	$480,000
Minus: Adjusted basis for depletion	160,000
Section 1231 gain	$320,000

The fair market value would then become your basis of the timber cut, and a later sale of the timber cut, including any byproduct or tree tops, would result in ordinary income or loss.

Cutting contract. If you own standing timber and dispose of it under a cutting contract, you must treat the disposal as a sale or exchange if you held the timber for more than one year before its disposal. You must also retain an economic interest in it.

The difference between the amount realized from the disposal of the timber and its adjusted basis for depletion is treated as gain or loss on its sale. Include this amount on Form 4797 along with your other section 1231 gains and losses to figure whether it is treated as capital or ordinary gain or loss.

Date of disposal. The date of disposal of the timber is the date the timber is cut. However, if you receive payment under the contract before the timber is cut, you may choose to treat the date of payment as the date of disposal. You can revoke the election by attaching a statement to the tax return for the tax year that the election is to be effective.

Owner. An owner is any person who owns an interest in the timber, including a sublessor and the holder of a contract to cut timber.

Economic interest. This means that you have acquired an investment interest in standing timber and get, by any form of legal relationship, income from cutting that timber, to get a return of your capital investment.

Example. You own standing timber that you have held for more than one year. It has an adjusted basis for depletion of $20 per MBF. You had no other gains or losses during the year. If you enter into a contract with a buyer that gives that person a right to cut and remove the timber for $40 per MBF, you will have a section 1231 gain of $20 per MBF on the disposal of the timber.

Tree stumps. Tree stumps are a capital asset if they are on land held by an investor who is not in the timber or stump business, either as a buyer, seller, or processor. Gain from the sale of stumps sold in one lot by such a holder is taxed as a capital gain. However, tree stumps held by timber operators, after the saleable standing timber was cut and removed from the land, are considered byproducts. Gain from the sale of stumps by lot or on a tonnage basis by such operators is taxed as ordinary income.

Coal and Iron Ore

If you own coal (including lignite) or iron ore mined in the United States for more than one year and dispose of it under a contract in which you retain an economic interest in the coal or iron ore, gain or loss is treated generally in the same manner as for timber sold under a cutting contract, explained previously.

You are considered an ***owner*** if you own or sublet an economic interest in the coal or iron ore in place. If the tax on any capital gains from the disposition of the coal or iron ore is less than the maximum rate for ordinary income, you are not entitled to the allowance for percentage depletion for the coal or iron ore. If you own merely an option to purchase the coal in place, you do not qualify as an owner. In addition, this special gain or loss treatment does not apply to income realized by an owner who is a co-adventurer, partner, or principal in the mining of coal or iron ore.

You have an economic interest if you have a legal interest in minerals in place and you have the right to income from the extraction and sale of the mineral, to which you must look for a return of your capital. More than one party may have an economic interest in a mineral deposit if each qualifies. If you have no legally enforceable right to share in the minerals in place, you do not have an economic interest in that mineral.

Gain or loss. The difference between the amount realized from disposal of the coal or iron ore and its adjusted basis for depletion, increased by certain expenditures not allowed as deductions for the tax year, is a section 1231 gain or loss, discussed under *Section 1231 property* in Chapter 11.

The expenses of making and administering the contract under which the coal or iron ore was disposed and the expenses of preserving the economic interest retained under the contract are not allowed as deductions in figuring taxable income. Rather, their total along with the adjusted depletion basis is deducted from the amount received to determine the gain. If the total of the expense of making and administering the contract plus the adjusted depletion basis is more than the amount received, the result is a loss. The date of disposal is considered to be the date the coal or iron ore is mined.

Sale of a Farm

The sale of your farm usually will involve the sale of both nonbusiness property (your residence) and business property (the land and buildings used in the farm operation and perhaps machinery and livestock). If you have a gain from the sale, you may be allowed to postpone paying tax on the gain on your residence. A loss on the sale of your business property is deducted as an ordinary loss if held more than 12 months. Losses, other than casualty, theft, etc., from nonbusiness property are personal losses and are not deductible. If payments for your farm are received in installments, you may be permitted to pay the tax on your gain over the period of years that the payments are received (see Chapter 12).

Allocation of sales price to assets. You must allocate the selling price to determine the amount received for each kind of property sold. The tax treatment of gain or loss on the sale of each asset is determined by the classification of the asset. If the sale of your farm includes your residence, land and buildings used in the farm operation, and livestock, farm machinery, and harvested crops, you must determine the part of the selling price that applies to each asset sold. All of the assets sold must be classified into one of the following classes:

1) Capital asset held one year or less,
2) Capital asset held more than one year,
3) Property (including real estate) used in your business and held one year or less (include draft, breeding, dairy, and sporting animals if held less than the holding periods discussed in Chapter 11 under *Section 1231 property*),
4) Property (including real estate) used in your business and held more than one year (include draft, breeding, dairy, and sporting animals only if held for the holding periods discussed in Chapter 11), or
5) Property held primarily for sale or which is of the kind that would be included in inventory if on hand at the close of your tax year.

For information on allocation of a lump-sum sales price to the assets acquired including special rules for allocation if the property sold is a trade or business, see *Allocating the Basis* in Publication 551, *Basis of Assets*.

Property used in farm operation. The rules for postponing tax on the gain on a voluntary sale, described later under *Your personal residence*, do not apply to the part of your farm used for business. Taxable gains and deductible losses on this property must be reported on your return for the year of the sale, and, if the property was held more than one year, may be reported as ordinary income or loss or included in Part I of Form 4797 (see Chapter 11).

Example. You sell your farm, including a residence, which you have owned since December 1987, and realize gain as follows:

	Farm with residence	Residence only	Farm without residence
Selling price	$182,000	$58,000	$ 124,000
Cost (or other basis) plus expenses of sale	40,000	10,000	30,000
Gain	$142,000	$48,000	$ 94,000

You may not postpone tax on the $94,000 gain from the sale of the property used in your farm business, even though you invest all of the selling price in another farm. All or a part of that gain may have to be reported as ordinary income from depreciation, soil and water conservation expenses, or land clearing expenses, and the balance treated as explained under *How to Use Form 4797* (see Chapter 11) to determine whether it is reported as capital or ordinary gain. The $48,000 gain from the sale of the residence is a capital gain. This gain is taxed unless you purchase or build another residence at a cost of $58,000 or more within the required period of time or exclude the gain as explained later.

Partial sale. If you sell a part of your farm, you must report any taxable gain or deductible loss on that part on your income tax return for the year of the sale. You may not wait until you have sold enough of the farm to recover its entire cost before reporting gain or loss.

Adjusted basis of the part sold. This is the properly allocated part of your original cost or other basis of the entire farm, plus or minus necessary adjustments for improvements, depreciation, etc., on the part sold.

Example. You bought a 600-acre farm for $700,000. The farm included land and buildings. The purchase contract designated $600,000 of the purchase price to the land. You later sold 60 acres of land on which you had installed a fence. Your adjusted basis for the part of your farm sold is 60/600 (1/10) of $600,000, or $60,000, plus any undepreciated cost of the fence on the 60 acres at the time of sale.

Assessing values for local property taxes. If you paid a flat sum for the entire farm and no other facts are available for properly allocating a part of your original cost or other basis to the part sold, you may use assessed value for local property taxes for the year of purchase as evidence of value to allocate the costs to basis.

Example. Assume that in the preceding example there was no breakdown of the $700,000 purchase price between land and buildings. However, in the year of purchase, local taxes on the entire property were based on assessed valuations of $420,000 for land and $140,000 for improvements, or a total of $560,000. The assessed valuation of land is $^3/_4$ of the total assessed valuation. You may apply the fraction $^3/_4$ to the $700,000 total purchase price to arrive at a basis of $525,000 for the 600 acres of land. The unadjusted basis of the 60 acres you sold would then be 60/600 (1/10) of $525,000, or $52,500. If your personal residence is on the farm, you must properly adjust the basis to exclude those costs from your farm asset costs, as discussed next.

Your personal residence. Your personal residence is a capital asset and not property used in the trade or business of farming. If you sell a farm that includes a house you and your family occupy, you must determine the part of the selling price and the part of the cost or other basis that are allocable to the residence. Your residence includes the immediate surroundings and outbuildings relating to it.

If you use a part of your residence for business, appropriate adjustment to the basis must be made for depreciation allowed or allowable. For more information on basis, see *Allocating the Basis* in Chapter 7.

Gain on sale of residence. When you h gain on the sale of your residence you must pone the tax on the gain if, within the perio beginning 2 years before and ending 2 year the sale, you buy and occupy another reside that you purchase at a cost equal to or mor the adjusted sale price of your old residenc

Gain from condemnation. If you have from a condemnation or sale under threat demnation, you may use the preceding rule regarding time for replacing your old reside postpone tax on the gain, rather than the ru discussed under *Postponement of Gain* in 13. To use the preceding rule you must cho treat the involuntary exchange as a volunta or exchange.

Age 55 or older. If you are 55 or older your residence, you may not have to pay ta any gain even though you do not invest in home.

A loss on your personal residence. on your personal residence either from a v sale or from condemnation or sale under th condemnation, cannot be deducted.

For more information on selling your hom Publication 523, *Tax Information on Selling Home.*

Foreclosure, Repossession, or Abandonment

If the owner (borrower) of property does n payments due on a loan secured by prope lender (mortgagee or creditor) may foreclo the mortgage or repossess the property. T closure or repossession is treated as a sa exchange from which the owner may reali or loss (discussed below). This is true eve property is voluntarily conveyed to the len

The owner who stops making payments secured loan may abandon the property. T abandonment is treated as a disposition fr which the owner may realize ordinary inco loss (see *Income or loss on abandonmen*

If the owner is personally liable for repa the loan, then the above sale or exchange abandonment of the property, may give ri cancellation of debt income to the owner *Cancellation of debt* and *Income or loss donment*, later).

Further, if investment credit property is ferred or abandoned, the owner may owe additional tax from recapture of the invest credit. See *Recapture of Investment Cred* Chapter 9.

Gain or loss on foreclosure or reposse The owner's gain or loss from the sale or exchange described above is generally fi the same way as a gain or loss from sale exchanges. The gain or loss is the differe between the owner's adjusted basis of th erty transferred and the amount realized. *How to determine gain or loss on sale*, e this chapter.

Amount realized. If the owner is not ally liable for repayment of the debt secu the property transferred, the amount real the owner includes the full amount of the canceled by the transfer. The full amount canceled debt is included even if the pro fair market value is less than the amount canceled debt.

If the owner is personally liable for the the fair market value of the property tran less than the canceled debt, the amount by the owner includes the canceled debt up to the fair market value of the propert case, the owner may be treated as receiving ordinary income from cancellation of debt for that part of the cancelled debt not included in the amount realized. See *Cancellation of debt*, later.

Capital or noncapital asset. If the property transferred is a capital asset, the owner's gain or loss is a capital gain or loss. If the property is not a capital asset, the gain or loss is an ordinary gain or loss, unless the property can be treated as a capital asset. See *Capital Assets* and *Noncapital Assets*, earlier.

Loss. A loss realized by the owner of property transferred through foreclosure or repossession, is figured in the same way as a loss from sales or exchanges generally. See *How to determine gain or loss on sale*, earlier.

No deduction is allowed for a loss on:

1) A personal residence or other property held for personal use, unless the loss is from a personal casualty or theft (and the $100 and 10% of AGI rules are met), or
2) The transfer of any property between related parties.

The owner will have a deductible loss if the adjusted basis of business or investment property transferred through foreclosure or repossession exceeds the amount realized (discussed earlier). Depending on whether the property is a capital asset, the loss may be an ordinary loss or a capital loss. See *Capital Assets*, earlier. For information on capital losses (normally from dispositions of section 1231 property), see *Sales and Exchanges* in Chapter 11.

Example. In 1988, Harold Boggs purchased farmland at a cost of $77,000. He paid $12,000 cash and obtained a $65,000 note secured by a mortgage on the property. Harold repaid $5,000 of the principal before he encountered financial difficulties and defaulted. At a foreclosure sale, the property was sold for $60,000, the unpaid balance of Harold's mortgage loan. His loss on the transaction is $17,000 ($77,000 basis minus $60,000 realized from the foreclosure and used to pay off the mortgage). Since Harold's foreclosed property was held for investment and is a capital asset held for more than 1 year, Harold's loss is treated as a long-term capital loss.

Gain. If the amount realized by the owner of property transferred through foreclosure or repossession is greater than the adjusted basis of the property, the excess is a gain, taxed in the same way as a gain from sales or exchanges generally. Gain from property held for personal use is taxed as a capital gain. Property used in a trade or business and held for more than one year is section 1231 property. Gain on sale or exchange of section 1231 property whether by foreclosure or repossession may qualify as long-term capital gain. See *Section 1231 Property* in Chapter 11.

Example. John purchased farm property for $34,000. He paid cash of $7,500 and assumed a $26,500 mortgage. During the year John had financial problems and the mortgage was subsequently foreclosed. The net proceeds from the foreclosure sale are $35,000, representing an increase in the value of the property. Of this amount, John received $8,500. His gain is $1,000 ($35,000 proceeds less $34,000 basis).

Cancellation of debt. If property is transferred through foreclosure or repossession to satisfy a debt secured by the property, the owner may be treated as receiving ordinary income from cancellation of debt. However, the income may not be recognized in certain cases, such as a debt cancellation intended as a gift, an insolvent debtor, or bankruptcy. See *Cancellation of Debt* in Chapter for more information.

The income from cancellation of debt is in addition to the gain or loss from the sale or exchange (transfer of property). This ordinary income from the cancellation of debt may arise if:

1) The owner is personally liable for repayment of the debt secured by the property transferred to satisfy the debt, and
2) The fair market value (FMV) of the property transferred is less than the amount of cancelled debt.

The amount realized by the owner from the transfer of property does not include the amount of cancelled debt that is more than the FMV of the property transferred. However, the owner may have ordinary income from cancellation of debt for that part of the cancelled debt not included in the amount realized.

Example. Frank is personally liable for repaying a mortgage on his investment property. After Frank stopped making payments on the mortgage, the lender foreclosed on it. The balance due was $7,500. When the property was transferred to the lender, its FMV was $6,000 and Frank's adjusted basis in it was $8,000. Frank realized a capital loss of $2,000 ($8,000 basis minus $6,000 amount realized) and ordinary income from cancellation of debt of $1,500 ($7,500 cancelled mortgage debt minus $6,000 FMV of property transferred to satisfy the debt).

Income or loss on abandonment. If the owner is personally liable for a debt secured by property that has been abandoned, and the debt is cancelled, the owner may be treated as receiving ordinary income from cancellation of debt to the extent of the unpaid debt. However, the income may not be recognized in certain cases, such as a debt cancellation intended as a gift, an insolvent debtor, or bankruptcy. See *Cancellation of Debt* in Chapter 4.

Loss from abandonment of business or investment property is deductible as an ordinary loss up to the amount of the property's adjusted basis when abandoned. However, if the property is later foreclosed on or repossessed, there may be gain or loss, figured as discussed earlier under *Gain or loss on foreclosure or repossession.* The abandonment loss is taken in the tax year in which the loss is sustained. The owner, however, may not deduct any loss on his or her personal residence or other property held for personal use, unless the loss is from personal casualty or theft.

Property transfer by insolvent taxpayer. If you are insolvent and transfer property that secures a debt to the lender to satisfy that debt, you must recognize any gain on the transfer. Recognize the gain to the extent the property's fair market value is more than its basis. If the amount of the debt is more than the fair market value of the property you transferred, the difference is generally taxable to you as cancellation-of-debt income. You can exclude from gross income, however, the cancellation of debt income up to the amount you are insolvent (excess of liabilities over assets).

Reporting income or loss. The owner of property transferred through foreclosure or repossession to satisfy a debt reports gain or loss on the transfer in the same way as for a gain or loss on sales or exchanges generally. See *How to Use Form 4797* in Chapter 11. If the owner who transfers or abandons property has taxable income from cancellation of debt, that income is reported on line 10 of Schedule F (Form 1040), if it relates to farm debt, and otherwise on line 22 of Form 1040.

Abandonment loss. The owner who abandons business or investment property may have an ordinary loss up to the amount of the property's adjusted basis when abandoned. This loss is reported on Form 4797, Part II, line 10.

Form 1099–A. If you are the owner of property that is secured by a loan and the lender acquires an interest in it, the lender may send you a Form 1099-A, *Information Return for Acquisition or Abandonment of Secured Property*, or with an equivalent statement. You may also get a Form 1099-A from the lender if you abandoned the secured property and the lender had reason to know that the property had been abandoned. The lender must give you a copy of the form by January 31, 1991.

11. Dispositions of Property Used in Farming

Certain farm property such as land, structures, and equipment used in farming, is section 1231 property. This kind of property is also called ***property used in farming.*** When sold it is reported differently than farm products. In addition, depreciation that you have taken on property used in farming may cause a gain on the disposition of that property to be treated as ordinary income. Gains or losses from property used in farming are reported on Form 4797.

Section 1231 Property

Property used in your farming business or for the production of rents or royalties and held more than one year is section 1231 property and is subject to section 1231 treatment. These rules apply to any property held more than one year that is subject to an involuntary conversion. Involuntary conversions are discussed in Chapter 13.

Sales or Exchanges

Sales or exchanges of the following types of property may result in gain or loss subject to section 1231 treatment.

Properties used in your business. Property used in your trade or business and held more than one year, or for the period specified—

Cattle and horses held for draft, breeding, dairy, or sporting purposes and held 2 years or longer from the date of acquisition.

Livestock (except cattle, horses, and poultry) held for draft, breeding, dairy, or sporting purposes and held 1 year or longer.

Depreciable property used in your business, such as farm machinery, trucks, barns, sheds, and livestock, except for gain from depreciation as explained later.

Real estate used in your business, such as your farm or ranch, except for gain from depreciation, or from soil and water conservation or land clearing expenses, explained later.

Unharvested crops on land used in farming if the crop and land are sold or exchanged at the same time and to the same person. Growing crops sold with a lease on the land, even though to the same person in a single transaction, are not included. Also not included is a sale or exchange of an unharvested crop with land if the taxpayer retains any right or option to reacquire the land directly or indirectly, other than a right customarily incident to a mortgage or other security transaction.

Timber (discussed under *Timber* in Chapter 10), coal or iron ore disposed of under a contract by which you retain an economic interest in the coal or iron ore.

Property held for the production of rents or royalties.

Your distributive share of partnership gains and losses from the sale or exchange of previously listed property held more than one year, or for the required period for certain livestock, except for gain attributable to depreciation as explained later.

Involuntary exchanges of business property and capital assets. Any involuntary exchange of business property and capital assets held for more than one year, or for the required period for certain livestock, resulting from—

Condemnations for public use. Condemnation losses on capital assets not held for the production of income, such as your personal residence, are not deductible and are not section 1231 losses. Condemnations are discussed in Chapter 13.

Casualty and theft gains and losses on property held for more than one year. These include casualty or theft to business property, property held for the production of rents and royalties, and investment property (such as notes and bonds). Insurance payments or other reimbursement must be taken into account in arriving at the net gain or loss. However, if your net losses from casualty or theft exceed gains from casualty or theft, they are not taken into account in the section 1231 computation. The excess net loss is deductible from ordinary income. Section 1231 does not apply to personal casualty gains and losses.
See *Personal casualty gains and losses*, under *Capital Assets* in Chapter 10; also see Chapter 13.

If you trade your property for unlike property. Property you trade for unlike property or for services, will generally result in a taxable transaction. (Like-kind property exchanges are discussed under *Nontaxable Exchanges* in Chapter 10.) To determine gain or loss, the fair market value of the property or services you receive is the amount received for your property. A taxable transaction will give rise to ordinary gain or loss if you trade an ordinary asset, such as a load of corn given in exchange for farm labor, and you generally will have a capital gain or loss if you trade a capital asset in a taxable exchange. If you trade property used in your farm business in a taxable transaction, your gain or loss is a section 1231 gain or loss.

Treatment of gains and losses. A gain or loss on the sale or exchange of section 1231 property may be a capital gain or loss or an ordinary gain or loss. Net section 1231 gain for the tax year is the excess of section 1231 gains over section 1231 losses. A net section 1231 loss is the excess of section 1231 losses over section 1231 gains.

Recapture of net ordinary losses. A net section 1231 gain is treated as ordinary income to the extent the gain does not exceed nonrecaptured net section 1231 losses taken in prior years. ***Nonrecaptured losses*** are net section 1231 losses deducted for your five most recent tax years that have not yet been applied (recaptured) against any net section 1231 gains in a tax year beginning after 1984. Your losses are recaptured beginning with the earliest year subject to recapture.

Your net section 1231 losses do not include recognized losses from involuntary conversions arising from fire, storm, shipwreck, or other casualty or theft.

Long-term capital gain or ordinary income? If you did not have any prior year section 1231 losses or they were recaptured in an earlier year, treat your net section 1231 gain for 1990 as long-term capital gain.

If you had such losses and they were not recaptured, your net section 1231 gain is treated as ordinary income up to the amount of your nonrecaptured losses. If the gain exceeds your losses, the excess is a long-term capital gain.

A net section 1231 loss. A net section 1231 loss for 1990 is treated as an ordinary loss.

See *How to Use Form 4797*, later, for additional information on the disposition of section 1231 property.

Depreciation Recapture on Personal Property

A gain on the disposition of section 1245 property is treated as ordinary income to the extent of depreciation allowed or allowable. See *Treatment of gain*, later.

Section 1245 property. This includes any property that is or has been subject to an allowance for depreciation and that is:

1) Personal property (both tangible and intangible),
2) An elevator or an escalator (placed in service before 1987),
3) Real property (not included in (4)) to the extent its adjusted basis has been reduced by certain amortization deductions including those for certified pollution control facilities, on-the-job training and child-care facilities, removal of architectural barriers to the handicapped and elderly, reforestation expenditures, or for which a section 179 deduction was taken, or
4) A special purpose structure or storage facility. This includes single purpose agricultural and horticultural structures and storage facilities used in connection with the distribution of petroleum or any primary product of petroleum. Such structures include fences used in connection with raising livestock, orchards, groves, and vineyards. It is also any other depreciable tangible property, ***except*** a building or its structural components, that is or has been an integral part of certain business activities, a research, or a storage facility (grain bins and silos, etc.) used in connection with these activities. These activities are manufacturing, production, extraction, or the furnishing of transportation, communications, electrical energy, gas, water, or sewage disposal services.

See *Modified Accelerated Cost Recovery System (MACRS)* in Chapter 8 and *MACRS* in Publication 534, *Depreciation*, for a discussion of depreciation including the modified accelerated cost recovery system (MACRS).

Buildings and structural components. The term building includes a house, barn, warehouse, or garage. The term structural component includes walls, floors, windows, doors, central air conditioning systems, light fixtures, etc.

Do ***not*** include a structure that is essentially an item of machinery or equipment as a building or structural component. Also, do not include a structure that houses property used as an integral part of an activity, if the use of the structure is so closely related to the use of the property that the structure clearly can be expected to be replaced when the property it initially houses is replaced.

The fact that the structure is specially designed to withstand the stress and other demands of the property and the fact that the structure cannot be used economically for other purposes indicate that it is closely related to the use of the property it housed. Thus, structures such as oil and gas storage tanks, grain storage bins, and silos are not treated as buildings.

A storage facility. A facility used mainly the bulk storage of fungible commodities is a age facility. To be fungible, a commodity must such that one part may be used in place of another. Bulk storage means storage of a commodity in a large mass before it is used. Thus, facility is used to store oranges that have been sorted and boxed, it is not used for bulk storag

Treatment of gain. The amount of gain tr as ordinary income on the sale, exchange, or involuntary conversion of section 1245 proper including a sale and leaseback transaction, is l ited to the ***lower*** of the amounts listed below.

1) The recomputed basis of the property mi the adjusted basis of the property, or
2) The amount realized from the sale minus adjusted basis of the property.

Recomputed basis. Recomputed basis of yo section 1245 property is the total of its adjuste basis plus depreciation and amortization (allo or allowable) included in the adjusted basis. Th includes depreciation and amortization adjustments on:

Property you exchanged for, or converted to, the present property in a like-kind exchan or involuntary conversion,

Property owned by someone before you, and

Property you presently own.

Depreciation, amortization, and investme credit. Depreciation includes the amount al or allowable for section 1245 property based useful life for depreciable property. The adjustment for depreciation also includes the ular or alternate ACRS and MACRS deduction claimed if the property is section 1245 recover property. ***Amortization***, for this purpose, inclu the section 179 deduction claimed (discussed lier in Chapter 8), and the deductions for: remo of certain barriers for the handicapped and eld child-care facilities or on-the-job training facili pollution control facilities, reforestation expend tures, and certain expenditures for certified historic structures. In figuring the deductions affecting the recomputed basis of section 1245 property, you should also include any basis adjustment that was made for ***investment cre*** claimed on the property. See *Investment credi* later.

Depreciation greater than gain. If the dep ciation is greater than your gain, the entire ga reported as ordinary income.

Gain greater than depreciation. If the ga greater than the depreciation, the gain due to depreciation is treated as ordinary income and excess is treated as a gain from a section 123 transaction. See *How to Use Form 4797*, late and the filled-in Form 4797 in Chapter 19.

Example 1. In February 1988 you purcha and placed in service for 100% use in your farming business a light-duty truck (5-year pro erty) with an adjusted basis of $10,000. You f your return on a calendar year. Your MACRS deductions for this truck were $2,000 ($10,00 .2) in 1988 and $3,200 in 1989. The MACRS deduction in 1990, the year of sale is $960. Y sell the truck in May 1990 for $7,000. Your adjusted basis is $3,840 ($10,000 minus $6,1 Your recomputed basis is $10,000 ($3,840 pl $6,160). The amount you treat as ordinary inc is the lower of the following:

1) Recomputed basis ($10,000) minus adju basis ($3,840) or $6,160, or
2) Amount realized ($7,000) minus adjusted basis ($3,840) or $3,160.

The lower of these two amounts, $3,160, is t amount of gain treated as ordinary income.

Example 2. On January 2, 1981, you bought a machine for $9,000. You claimed $600 deprecia- on on it each year and sold it for $8,000 on July , 1990. Your adjusted basis on the date of sale ras $3,300 ($9,000 less $5,700 (the $600 depre- iation for each of the years 1981 through 1989 nd $300 for 1990)). Your recomputed basis is 9,000 (your total depreciation deductions plus our adjusted basis). The amount you treat as rdinary income is the lower of the following:

1) Recomputed basis ($9,000) minus adjusted basis ($3,300) or $5,700, or
2) Amount realized ($8,000) minus adjusted basis ($3,300) or $4,700.

he lower of these two amounts, $4,700, is the mount of gain treated as ordinary income. ecause the gain ($4,700) is less than the total epreciation ($5,700), the entire gain is included s ordinary income.

Section 1231 gain. Gain on certain disposi- ons of depreciable property and land used in our farming business may be section 1231 gain s explained earlier in this chapter. However, all or part of the gain on a disposition of such property nay also be treated as ordinary income under the ules of this chapter. In this case, any part of your ain that is not treated as ordinary income under hese rules is reported as section 1231 gain.

Disposition of plants and animals. If you nade the election not to apply the uniform capital- zation rules, you must treat any plant or animal (if he animals were produced in 1987 or 1988) that you produce as section 1245 property. Further, you must *"recapture" the preproductive xpenses* that you would have capitalized if you ad not made the election by treating these xpenses as ordinary income when you determine your gain on selling or disposing of the property. Show these expenses on line 22, Part III, of Form 4797. To figure the amount of these expenses, you may use the farm-price method or the unit- vestock method discussed in Chapter 3. You may not, however, use the amounts available under the safe-harbor livestock method. For information see *Uniform Capitalization Rules*, in Chapter 7.

Investment credit. On a disposition of section 1245 property or section 1250 property, any reduction in basis by part or all of the investment credit claimed on property is considered a deduc- ion allowed for depreciation.

If a disposition results in the recapture of nvestment credit, the depreciable basis of the roperty immediately before the disposition result- ng in the recapture is increased by part or all of he recapture amount. This amount is any ncrease in tax that must be paid plus any djustment to investment credit carrybacks or arryforwards. For more information, see nvestment credit recapture Form 4255, *Recapture nvestment Credit.*

Tax-free exchange or involuntary onversions. Special rules apply to property eceived as a gift or by transfer at death, and to roperty received in certain distributions and tax- ree exchanges. Additional information on these ubjects may be found under *Depreciation Recapture on Personal Property* in Publication 544, *Sales and Other Dispositions of Assets.*

Use ***Part III of Form 4797**, Sales of Business Property*, to report gain from the sale, exchange, r involuntary conversion of section 1245 prop- rty.

Depreciation Recapture on Real Property

A gain on the disposition of section 1250 property s treated as ordinary income to the extent of additional depreciation allowed or allowable on the property.

Section 1250 property. This includes all real property that is subject to an allowance for depreciation and that is not or has never been section 1245 property or section 1245 recovery property. It also includes leased property (such as a building) to which the lessee has made improvements that are subject to an allowance for depreciation, and the cost of acquiring a lease. A fee simple interest in land is not included because it is not depreciable.

The deductions taken under either ***ACRS or MACRS*** are treated as ordinary income under section 1245 except for the deductions taken on the following properties which are treated as section 1250 property:

1) 15–year, 18–year, or 19–year real property and low-income housing that is residential rental property,
2) 15–year, 18–year, or 19–year real property and low-income housing that is used mostly outside of the United States,
3) 15–year, 18–year, or 19–year real property and low-income housing on which the alternate ACRS method of depreciation is taken, and
4) Low-income property.

The ordinary income rules for gains on section 1250 property dispositions do not apply to an item if:

1) You figure depreciation on the property using the straight line method or any other method as long as that method does not result in depreciation that is more than the amount that is figured by the straight line method, and you have held the property more than a year,
2) You realize a loss on the sale, exchange, or involuntary conversion of the property,
3) You chose the alternate ACRS method for the types of 15–, 18–, or 19–year real property covered by the section 1250 rules, or
4) You dispose of residential rental property or nonresidential real property placed in service after December 31, 1986 (or after July 31, 1986, if the election to use the MACRS method was made). Additional depreciation is not treated as ordinary income on the disposition of residential rental property and nonresidential real property because these properties are now depreciated using the straight line method. See *Items in recovery classes* in Chapter 8 for a definition of residential and nonresidential real property.

Treatment of gain. If you had a gain on the disposition of depreciable real property and the depreciation you took under the depreciation method you used is more than the depreciation that would have been allowable under the straight line method for the same period, you must report part of your gain as ordinary income. The balance is treated as a gain from a section 1231 transaction as discussed in *How to Use Form 4797,* later in this chapter. However, if you held the property for more than one year and depreciated it exclusively on the straight line method, your gain is not subject to this treatment and you treat the entire gain as a gain from a section 1231 transaction. There are special rules for figuring the amount that is treated as ordinary income if certain substantial improvements were made to the property disposed of.

Like-kind exchange or involuntary conversion. Even though your disposition may not otherwise be taxable, you may be subject to tax on a like-kind exchange or an involuntary exchange of your property. For example, even though you postpone paying tax, a part of the gain from additional depreciation may be taxed.

Additional information on section 1250 property is in Publication 544 under *Depreciation Recapture on Real Property.*

Other Farm Property

This section discusses gain on the disposition of farmland for which you were allowed deductions for:

Soil and water conservation expenditures or land clearing expenditures (section 1252 property), and

Property for which you were allowed to exclude from income certain cost sharing payments (section 1255 property).

Farmland (under section 1252). If you had a gain on the disposition of farmland that you held less than 10 years, on which you were allowed deductions for soil and water conservation expenditures or land clearing expenditures discussed in Chapter 6, you must report a specified part of the gain as ordinary income and treat the balance as section 1231 gain.

Amount to report as ordinary income. You report as ordinary income the lesser of: (1) the total amount of deductions allowed for soil and water conservation and land clearing expenditures times the applicable percentage, discussed below, or (2) your gain (the result of subtracting the adjusted basis from the amount realized for a sale, exchange or involuntary conversion, or the fair market value for all other dispositions).

Applicable percentage. The applicable percentage of soil and water conservation and land clearing expenditures to be reported as ordinary income is based on the length of time you held the land. If you dispose of your farmland within 5 years after the date you got it, the applicable percentage of these expenditures to be reported as ordinary income is 100%. If you dispose of the land within 6 to 9 years after you got it, the applicable percentage is reduced by 20% a year for each year you hold the land after the 5th year. If you dispose of the land 10 years or more after you got it, the applicable percentage is 0, and the entire amount of the gain is a section 1231 gain.

Example. You acquired farmland on January 19, 1983. On October 2, 1990, you sell the land at a $30,000 gain. Between January 1 and October 2, 1990 you make soil and water conservation expenditures of $15,000 that are fully deductible in 1990. The applicable percentage is 40% since you sold the land within the 8th year after you got it. Thus, you treat $6,000 (40% of $15,000) of the $30,000 gain as ordinary income and the $24,000 balance as a section 1231 gain.

Part III, Form 4797. Use ***Part III of Form 4797*** to figure a gain from the sale, exchange, or involuntary conversion of section 1252 property.

Section 1255 property. If you receive certain cost-sharing payments on property that you exclude from income (discussed in Chapter 4) and you have a gain on the disposition of the property, you may have to report a certain part of the gain as ordinary income and treat the balance as a section 1231 gain. If you elected not to exclude these payments you will not have to recognize ordinary income on a disposition of this property.

Report as ordinary income. You report as ordinary income the lesser of: (1) the applicable percentage of the total cost-sharing payments, or (2) the gain on the disposition of the property. However, this section only applies to a gain or a part of a gain that is not recognized as ordinary income under any other Internal Revenue Code section.

Applicable percentage. The applicable percentage of the cost-sharing payments to be reported as ordinary income is based on the length of time you hold the property after receiving the payments. If the property is held less than 10 years, the percentage is 100%. After 10 years, the percentage is reduced by 10% a year or part of a year until the rate is 0%.

How to Use Form 4797

Form 4797, *Sales of Business Property*, consists of five related parts (see the illustrated form in Chapter 19). The chart in this chapter shows examples of items reported on Form 4797 and refers to the part on which they first should be reported.

Installment sales. Taxable gain from payments you receive each year under the installment method of accounting on the sale of business property has to be included with other section 1231 gains and losses. Therefore, your gain from the sale may be reported as capital gain in some years and as ordinary gain in other years. If you sell depreciable or amortizable property, all or part of the income (other than interest) from your annual collections representing depreciation or amortization may be ordinary income. You must report in the year of sale any depreciation recapture, including the section 179 deduction, as ordinary income up to the amount of gain. For more information on installment sales, see Chapter 12.

If the disposition of your business assets was eligible for section 1231 treatment in the year of the installment sale (that is, the gains were included with other gains and losses from the disposition of section 1231 assets), then the gain from the installment payments received in later years will continue to qualify for section 1231 treatment.

Examples of items reported on Form 4797. Columns (b) and (c) show where to make the first entry on Form 4797. (a)	Held one year or less (b)	Held more than one year (c)
1 Depreciable trade or business property:		
a Sold or exchanged at a gain	Part II	Part III (1245)
b Sold or exchanged at a loss	Part II	Part I
2 Depreciable residential rental property:		
a Sold or exchanged at a gain	Part II	Part III (1250)
b Sold or exchanged at a loss	Part II	Part I
3 Cattle and horses used in a trade or business for draft, breeding, dairy, or sporting purposes:		
a Held for less than 2 years from acquisition date, sold at a gain or loss	Part II	Part II
b Held for 2 years or more from acquisition date:		
(1) Sold at a gain	Not applicable	Part III (1245)
(2) Sold at a loss	Not applicable	Part I
(3) Raised cattle and horses sold at a gain	Not applicable	Part I
4 Livestock other than cattle and horses used in a trade or business for draft, breeding, dairy, or sporting purposes:		
a Held less than 1 year from acquisition date, sold at a gain or loss	Part II	Part II
b Held for 1 year or more from acquisition date:		
(1) Sold at a gain	Part II	Part III (1245)
(2) Sold at a loss	Part II	Part I
(3) Raised livestock sold at a gain	Part II	Part I
5 Farmland, held less than 10 years upon which soil, water, and/or land clearing expenses were deducted:		
a Sold at a gain	Part II	Part III (1252)
b Sold at a loss	Part II	Part I
6 Disposition of cost-sharing payment property described in section 126	Part III (1255)	Part III (1255)

12. Installment Sales

An installment sale is a sale of property where one or more payments on the sale is to be received after the close of the tax year. If you finance the buyer's purchase of your property yourself, instead of having the buyer get a loan or mortgage from a bank, you probably have an installment sale. However, you do not have an installment sale if the buyer gives a deed of trust or mortgage to a bank or trust company and then pays you the total selling price.

The buyer's "installment obligation" to make future payments to you might be in the form of a deed of trust, a note, a land contract, a mortgage, or some other evidence of the buyer's indebtedness to you. The rules discussed in this chapter apply regardless of the form of the installment obligation.

You generally report your gain on an installment sale only as you actually receive the payments. Each payment you receive consists of three parts:

1) Return of your investment (basis) in the property sold,

2) Gain on the sale, and

3) Interest.

You are taxed only on the part of each payment that represents interest on the sale and your profit on the sale. In this way, the installment method of reporting income relieves you of paying tax on income that you have not yet collected. However, for a sale of depreciable property, you must report in the year of sale any depreciation recapture income up to the amount of the gain. In this case any gain in excess of the recapture amount is taken into account under the installment method.

Installment sale form. Each year, including year of sale, you must report your income from installment sale on Form 6252, *Installment Sale Income*. Attach this form to your tax return.

The gain you have from an installment sale be treated as capital gain if the property you so was a capital asset. However, if you took deprec ation deductions on the asset, part of your gain may be reported in the year of sale as ordinary income. See Chapter 11.

Disposition of installment obligation. If you sell or discount an installment obligation, you usually have a gain or loss to report. The gain or loss is considered to be gain or loss on the sale the property for which you received the installm obligation. If this takes place during the year of sale, report your entire gain on your return for th year. You do not have an installment sale. If it takes place in a later year, you may have a disp sition of an installment obligation. See *Disposi- tions of Installment Obligations* in Publication 5 for information on the disposition of an installm obligation.

Cancellation of installment obligation. If a installment obligation is cancelled or otherwise becomes unenforceable, it is treated as a dispo tion other than a sale or exchange. Your gain or loss is the difference between your basis in the obligation and its fair market value at the time y cancel it. (A reduction in the selling price chang the gross profit and gross profit percentage.) Se Publication 537 for information on the dispositio of installment obligations.

Installment obligation transferred becaus of death. If an installment obligation is transferred as a result of the death of the seller (or other holder of the obligation), the transfer is not treated as a disposition of the obligation. Unreported gains from the installment obligation are treated as income in respect of a decedent. This means that whoever receives the obligation as result of the seller's death is taxed on the payments in the same way as the seller would have been if the seller had lived to receive the payments.

However, if the installment obligation is canceled, becomes unenforceable, or is transferre the buyer, it is treated as a disposition of the obligation. The estate of the seller must figure gain or loss on the disposition.

For information on disposition of installment obligations, see Publication 537.

Sale at a loss. If your sale results in a loss, yo may not use the installment method. If the loss on an installment sale of business assets, you deduct it only in the tax year of sale. You cann deduct a loss on the sale of property owned fo personal use.

Electing out. You can choose not to have the installment sale rules apply to your sale. If you make this choice, you must report your entire in the year of sale, even though you will not be paid all of the selling price until later. You then not have to report any gain from the payments receive in later years.

If you want to make this choice, do not repo your sale on Form 6252. Instead, report it on Schedule D (Form 1040) or Form 4797, which is appropriate. See *Electing Out* in Publication and the instructions for Schedule D and for Fo 4797 for more information on choosing not to the installment method.

When to elect out. You must make the el tion not to have the installment sale rules app the due date, including extensions, for filing y tax return for the year in which the sale took place. Once made, the election generally can be changed.

iguring Installment Sale Income

u must allocate the payments you receive each ar from an installment sale.

terest income. If interest is included in a yment, you must separately report all the terest as ordinary income. Interest is generally t included in a down payment. However, you ay have to treat a part of each later payment as terest, even if it is not called interest in your greement with the buyer. See *Unstated Interest*, ter.

ross profit percentage. A certain percentage f each payment (after subtracting out interest) ust be reported as gain from the sale. This perentage usually remains the same for each ayment you receive. It is called the "gross profit ercentage," and is figured by dividing your gross rofit from the sale by the contract price.

Example. You sell property at a contract price f $2,000, and your gross profit will be $500. Your ross profit percentage is 25% ($500 divided by 2,000). After subtracting out interest, 25% of ach payment, including the down payment, hould be reported as your gain from the sale for he tax year the payment is received.

Gross profit. For an installment sale, gross profit s the amount of gain you report on the installment method. It is the total amount of your gain from the sale minus:

1) The amount of gain you must report as ordinary income in the year of sale because of depreciation recapture income (including the section 179 deduction you claimed), and
2) The amount of gain you can postpone or exclude on the sale of your home.

Gain reported in year of sale. For sales of depreciable property, figure your depreciation recapture income (including the section 179 deduction recapture) in Part III of Form 4797. Report the recapture income in Part II of Form 4797 as ordinary income in the year of sale. If the amount of the gain equals or is less than the recapture income, you do not have an installment sale. Any gain that exceeds the recapture income can be reported on the installment method if the sale is an installment sale. For more information on the section 179 deduction, see *Section 179 Deduction* in Chapter 8. See *Depreciation Recapture on Personal Property* and *Depreciation Recapture on Real Property* in Chapter 11 for more information on depreciation recapture.

To figure your gross profit, you must know your basis in the property you sold and the selling price. You add the commissions, any other expenses paid on the sale, and the depreciation recapture income reported in the year of sale to your basis. You then subtract this total from the selling price. If the property you sold was your home, also subtract any gain you can postpone or exclude. The result is your gross profit from the sale.

Basis. Basis is a way of measuring your investment in the property you are selling. It is defined and discussed in Chapter 7. For the purpose of figuring gross profit on installment sales, selling expenses and recapture income are always added to basis. We refer to this total as "installment sale basis" in this chapter.

Selling price. The selling price for an installment sale is the entire cost of the property to the buyer. It includes any money and the fair market value of any property you are to receive. It also includes any debt the buyer pays, assumes, or takes the property subject to. The debt could be a note, mortgage, or any other liability, such as a lien, accrued interest, or taxes you owe on the property. If the buyer pays any of your selling expenses for you, that amount is also included in the selling price. The selling price does not include interest, whether stated or unstated.

Selling price reduced. If the selling price is reduced at a later date, the gross profit on the sale will also change. You must then refigure the gross profit percentage for the remaining payments. You cannot go back and refigure the gain you reported in earlier years.

Example. In 1988, you sold land with a basis of $40,000 for $100,000 and have a gross profit of $60,000. You received a $20,000 down payment and the buyer's note for $80,000. The note payments are $20,000 each, plus 12% interest, beginning in 1989. Your gross profit percentage is 60%. You reported a gross profit of $12,000 on the payments received in 1988 and 1989. In 1990, you and the buyer agree to reduce the purchase price to $85,000 and the payments during 1990, 1991, and 1992 are reduced to $15,000 for each year.

Your adjusted gross profit on the sale is $45,000. You subtract the total amount of profit reported in 1988 and 1989, or $24,000, from the adjusted gross profit to determine the remaining profit to be reported. The remaining profit of $21,000 to be reported is divided by the selling price to be received of $45,000 to get the new gross profit percentage of 46.67%. You will report a gross profit of $7,000 on each of the $15,000 installments due in 1990, 1991, and 1992.

Contract price. The contract price is the total amount of all the principal payments you are to receive on the installment sale. It includes payments you are considered to receive, even though you are not paid anything directly. See *Payments*, later.

If the selling price is payable partly in cash, with the remainder secured by a mortgage payable from the buyer to you, then the contract price equals the selling price.

Installment sales to related persons. Special rules apply if you sell property to a related person under the installment method and that related person then sells or otherwise disposes of the property before you receive all the payments from the first sale. Spouses, children, grandchildren, brothers, sisters, and parents are all considered related persons. A partnership or corporation that you have an interest in, or an estate or trust that you have a connection with, can also be considered a related person. For more information, see Publication 537.

Trading property for like-kind property. If you trade property for the same kind of property, you can often postpone reporting part of the gain. See *Nontaxable Exchanges* in Chapter 10 for a discussion of like-kind property. If the trade includes an installment obligation, the following rules apply.

1) The contract price does not include the fair market value of the like-kind property you receive in the trade.
2) The gross profit is reduced by any gain on the trade that can be postponed.
3) Like-kind property received in the trade is not considered a payment on the installment obligation.

Payments

You must figure your profit on the payments you receive, or are treated as receiving, during the year from an installment sale, including the down payment and each later payment of principal on the buyer's debt to you. The sum of all these payments is the contract price.

In certain situations, you will be considered to have received a payment, even though the buyer does not pay you directly. These situations arise if the buyer takes over or pays off any of your debts, such as a loan, or any of your expenses, such as a sales commission.

Buyer assumes expenses. If the buyer assumes and pays expenses you have in connection with selling your property, it is considered a payment to you in the year of sale. The expenses are included in both the selling price and contract price when figuring the gross profit percentage.

Mortgage assumed. If the buyer assumes (or pays off) your mortgage, or otherwise takes the property subject to it, the following rules apply.

Mortgage less than basis. If the buyer assumes a mortgage that is less than your installment sale basis in the property, it is not considered a payment to you. The contract price equals the selling price minus the amount of the mortgage. This difference is all that you will directly collect from the buyer.

Example. You sell property with a basis to you of $19,000 and you have selling expenses of $1,000. The buyer assumes your existing mortgage of $15,000 and, in addition, agrees to pay you a total of $10,000, a cash down payment of $2,000 and $2,000 (plus 12% interest) in each of the next 4 years.

The selling price is $25,000 ($15,000 + $10,000). The contract price is $10,000 ($25,000 − $15,000 mortgage). Your gross profit is $5,000 ($25,000 − $20,000 (basis plus selling expenses)), and your gross profit percentage is 50% ($5,000 divided by $10,000). Therefore, you must report half of each $2,000 payment you receive as gain from the sale. You must also report all of the interest you receive as interest income.

Mortgage more than basis. If the buyer assumes a mortgage that is more than your installment sale basis in the property, you recover your entire basis. You are also relieved of the obligation to repay the amount borrowed. The portion in excess of your basis is treated as a payment received in the year of sale. This is in addition to the buyer's other payments.

To figure the contract price, subtract the mortgage from the selling price. This is the total you will actually receive from the buyer. To this amount add the "payment" you are considered to receive (the difference between the mortgage and your installment sale basis). The contract price is then the same as your gross profit from the sale. Therefore, if the mortgage the buyer assumes is equal to or more than your installment sale basis, the gross profit percentage will always be 100%.

Example. The selling price for your property is $9,000. The buyer will pay you $3,000 (plus 12% interest) over the next 3 years, and also assumes an existing mortgage of $6,000. Your basis in the property is $4,400 and you have selling expenses of $600, for a total of $5,000. The part of the mortgage that is more than your installment sale basis is $1,000 ($6,000 − $5,000). This amount is included in the contract price and is also treated as a payment you receive in the year of the sale. The contract price is $4,000 ($9,000 − $6,000 + $1,000).

Your gross profit on the sale is also $4,000 ($9,000 − $5,000). Therefore, your gross profit percentage is 100%. As the buyer pays you the $3,000, you must report 100% of each payment as gain from the sale. You must also treat the $1,000 difference between the mortgage and your installment sale basis as a payment, and report 100% of it as gain in the year of the sale.

Debts. If the buyer pays off any of your debts—such as a loan or back taxes—it may be considered a payment to you in the year of the sale.

If the buyer assumes the debt instead of paying it off as his or her own, only a part of it may have to be treated as a payment. Compare the amount of the debt to your installment sale basis in the property being sold. If the debt is less than your installment sale basis, none of it is treated as a payment. If it is more, only the difference is treated as a payment. If the buyer assumes more than one debt, any part of the total that is more than your installment sale basis is considered a payment. This follows the same rules discussed above under *Mortgage assumed*.

However, these rules apply only to two types of debts that the buyer assumes:

1) Those that you acquired in connection with your ownership of the property you are selling, such as a mortgage, lien, overdue interest, or back taxes, and
2) Those that you acquired in the ordinary course of your business, such as a balance due for inventory you purchased.

If the buyer assumes any other type of debt, such as a personal loan, it is treated the same as if the buyer had paid off the debt at the time of the sale. The value of the assumed debt is considered a payment to you in the year of the sale.

Payments of property. If you receive property rather than money from the buyer, it is still considered a payment. However, see *Trading property for like-kind property,* earlier. The value of the payment is the property's fair market value on the date you receive it.

Fair market value. This is the price at which the property would change hands between a buyer and a seller, neither being required to buy or sell, and both having reasonable knowledge of all the necessary facts. If your installment sale fits this description, the value assigned to property in your agreement with the buyer is good evidence of its fair market value.

Third-party notes. If the property the buyer gives you is a third-party note (or other obligation of a third party), you are considered to have received a payment equal to the note's fair market value. Because the note is itself a payment on your installment sale, any payments you later receive on the note from the third party are not considered payments on your sale. If the fair market value of the note was less than its face value, a part of each payment you receive on it must be reported as ordinary income.

Example. You sold real estate in an installment sale. As part of the down payment, the buyer assigned to you a $5,000, 12% note of a third party. The fair market value of the third-party note at the time of your sale was $3,000. This amount, and not $5,000, is a payment to you in the year of sale. Because the third-party note had a fair market value equal to 60% of its face value ($3,000 divided by $5,000), 60% of each payment of principal you receive on this note is a return of capital. The remaining 40% is ordinary income. The interest you receive is reported in full as ordinary income.

Bonds. A bond or other evidence of indebtedness you receive from the buyer that is payable on demand is treated as a payment in the year you receive it. If you receive a government or corporate bond that has interest coupons attached or that can be readily traded in an established securities market, you are considered to have received a payment equal to the bond's fair market value. Accrual basis taxpayers, see section 15A.453–1(e)(2) of the regulations.

Buyer's note. The buyer's note (unless it is payable on demand) is not considered a payment on the sale. Its full face value is included when figuring both selling price and contract price. The payments you receive on the note are reported on the installment method.

Guarantees. If a third party or government agency guarantees the buyer's payments to you on an installment obligation, the guarantee itself is not considered to be a payment.

Deposits. Deposits that you receive before the year of sale should be treated as payments in the year of sale if, under the contract, they become part of the down payment.

Installment obligation used as security (pledge rule). If you use an installment obligation to secure any loan (debt), the net proceeds from the loan are treated as a payment on the installment obligation. This rule applies if the sales price of certain property was more than $150,000. It does not apply to the sale of farm property. For more information, see *Installment obligation used as security* under *Payments* in Publication 537.

Unstated Interest

Both the buyer and the seller must treat a part of each installment sale payment as interest. For the most part, this interest will be stated in the sales agreement. However, in some situations you may have to treat a certain amount of each payment as interest, even though it is not called interest in your agreement with the buyer. This amount, generally referred to as unstated interest, reduces the stated selling price of the property and increases the seller's interest income and the buyer's interest expense.

For a detailed discussion of the unstated interest rules, get Publication 537.

Installment Sale of Entire Farm

The installment sale of an entire farm for one overall price under a single contract is not the sale of a single asset. The sale generally includes the sale of real and personal property that may be reported on the installment method. The selling price must be broken down to determine the amount received for each class of asset.

The tax treatment of the gain or loss on the sale of each class of assets is determined by its classification as capital asset or property used in the business, and by the length of time held. Separate computations must be made to figure the gain or loss for each class of asset sold. See *Sale of a Farm,* in Chapter 10.

Example. On January 3, 1990, you sold your farm, including the equipment and livestock, for a lump-sum price. You received a $50,000 down payment and the buyer's note for $200,000. In addition, the buyer assumed an outstanding $50,000 mortgage on the property. The total selling price was $300,000. The note payments of $25,000 each, plus adequate interest, were due July 1 and January 1. Your selling expenses were $15,000.

The adjusted basis and depreciation claimed on each asset sold are as follows:

Asset	Depreciation Claimed	Adjusted Basis
Residence		$30,000
Farmland		61,250
Buildings	$23,500	36,500
Fences	3,525	975
Cattle held 2 years or more	11,600	8,400
Equipment	3,980	11,020
Tractor	6,634	18,366
Cattle held less than 2 years	2,464	1,536

No depreciation was claimed on the residence or farmland. Straight line depreciation was claimed on the buildings and fences which were acquired in 1978. The cattle held 2 years or more are 5–year property and were depreciated under ACRS. The cattle held less than 2 years are 5–year property and were depreciated under MACRS. The equipment and tractor are 7–year property and were depreciated under MACR See *Recapture of Investment Credit* in Chap for a discussion of the investment credit rec rules.

The assets included in the sale, their sellin prices based on their respective values, the s expenses allocated to each asset, the adjus basis, and gain for each asset are shown in th following schedule. The selling expense for e asset is 5% of the selling price ($15,000 selli expenses divided by $300,000 selling price). (stock and produce held for sale all were sold before the end of 1989 in anticipation of sell the farm. You also did not take a section 179 deduction for any of the assets.)

	Selling price	Selling expense	Adjusted basis
Residence	$ 50,000	$ 2,500	$ 30,000
Farmland	125,000	6,250	61,250
Buildings	55,000	2,750	36,500
Fences	5,000	250	975
Cattle which were held 2 years or more	20,000	1,000	8,400
Equipment	15,000	750	11,020
Tractor	25,000	1,250	18,366
Cattle which were held less than 2 years	5,000	250	1,536
	$300,000	$15,000	$168,047

The buildings which were acquired in 1978, when the farm was purchased, are section 12 property. There is no depreciation recapture income because the buildings were depreciat using the straight line method. The fences, wh were also depreciated on the straight line me are section 1245 property.

All the depreciation of $3,525 on the fence depreciation recapture income because it is l than the gain on the fences. The remaining g $250 can be reported on the installment met The cattle held 2 years or more, which were acquired in 1987, are section 1245 recovery p erty. Since the gain on the cattle of $10,600 i less than the depreciation claimed ($11,600), total gain is depreciation recapture income.

The equipment and tractor, both of which w acquired in 1989, are section 1245 property. L the cattle, the full gain on each ($3,230 and $5,384, respectively) is depreciation recaptur income. The cattle held less than 2 years wer acquired in 1988 and are section 1245 prope The gain of $3,214 is depreciation recapture income to the extent of the depreciation clai ($2,464).

The total recapture income reported in Par Form 4797 is $25,203. The gains on the catt held 2 years or more, equipment, and tractor reported in full in the year of sale. Therefore, these items are not included in the installmen sale computation. The part of the gains repo as recapture income on the fences and the c held less than 2 years ($3,525 and $2,464) i added to the adjusted basis of the property w making the installment sale computations.

The $60,000 of the $300,000 total selling which represents the selling price of the catt held 2 years or more, the equipment, and the tor is removed from the total selling price be the gain on these items is reported in the ye sale. The selling price for the installment sal $240,000.

The assets included in the installment sale selling price, their "installment sale basis," a the gross profit on each are shown in the fo table.

	Selling price	Install-ment Sale basis	Gross profit
esidence	$ 50,000	$ 32,500	$ 17,500
rmland	125,000	67,500	57,500
ildings	55,000	39,250	15,750
nces	5,000	4,750	250
ttle held less than 2 years	5,000	4,250	750
	$240,000	$148,250	$ 91,750

The gain on the residence will be reported as pital gain unless you can postpone or exclude l or part of the gain as explained under *Gain on ale of residence* under *Sale of a Farm* in Chapter). Since the ordinary income part of the gain on e fences is reported in the year of sale, the maining gain ($250) and the gain on the land nd buildings will be reported as section 1231 in. Since the holding period for the cattle is less an 2 years, all of the $750 gain will be reported s ordinary income.

The contract price is $190,000 ($240,000 (sell- g price) minus $50,000 (mortgage assumed)). he gross profit percentages (gross profit divided y the contract price) for the assets are figured as llows:

	Percentage
esidence ($17,500 ÷ $190,000)	9.2105
armland ($57,500 ÷ $190,000)	30.2632
uildings ($15,750 ÷ $190,000)	8.2895
ences ($250 ÷ $190,000)	0.1316
attle held less than 2 years ($750 ÷ $190,000)	0.3947
otal	48.2895

Your installment income for 1990 for each asset s the gross profit percentage for that asset times he amount received in 1990 on the installment ale. Each payment received on the sale must be llocated between the installment sale and the ale of assets which cannot be reported on the nstallment method. The total payment to be eceived under the contract is $250,000. The total elling price of the cattle held 2 years or more, the quipment, and the tractor is $60,000. The sale of hese assets must be reported in the year of sale. The remaining $190,000 ($250,000 − $60,000) is he total to be received on the installment sale. Therefore, 76% ($190,000 ÷ $250,000) of each ayment is installment income.

The total of $75,000 received in 1990 is the own payment of $50,000 and the July 1 nstallment of $25,000. Only 76% of $75,000, or 57,000, is the amount received in the year of sale hat applies to the installment sale.

	Income
esidence—9.2105% of $57,000	$ 5,250
armland—30.2632% of $57,000	17,250
uildings—8.2895% of $57,000	4,725
ences—0.1316% of $57,000	75
attle held less than 2 years—0.3947% of $57,000	225
otal installment income for 1990	$27,525

The installment sale must be reported on Form 252. The amounts from Form 6252 are then eported on Form 4797 and Schedule D (Form 040). The computations shown in the example ould be included in schedules, as needed, and ttached to Form 6252. Enter the $5,250 gain on e sale of your residence on Schedule D as a ng-term capital gain unless you can postpone or xclude the gain. The gains on the land, buildings, nd fences may be capital gain or ordinary gain hen compared with certain other gains and sses. See *How to Use Form 4797*, in Chapter 1. The $225 gain on the cattle held less than 2 ears is ordinary income reported in Part II of orm 4797.

You figure installment ***income for years after 1990*** by applying the same gross profit percentages to the payments you receive each year on the buyer's note. If you receive $38,000 (76% of $50,000) on the installment sale during the year, you will realize income for that year as follows:

	Income
Residence—9.2105% of $38,000	$ 3,500
Farmland—30.2632% of $38,000	11,500
Buildings—8.2895% of $38,000	3,150
Fences—0.1316% of $38,000	50
Cattle held less than 2 years—0.3947% of $38,000	150
Total installment income	$18,350

Treat your gain each year on capital assets you held more than one year and assets you used in business but held one year or less the same as you treated your gain last year on the same assets. In some years you may treat the gain on assets you used in business and held more than one year as capital gain, and in other years as ordinary gain, since you must make a separate comparison of certain gains and losses for each year you receive payments on the buyer's note to determine whether they are ordinary or capital gains and losses. The interest received with each payment is included in full as ordinary income. For more information, see *How to Use Form 4797*, in Chapter 11.

Summary. The installment income (rounded to the nearest dollar) from the sale of the farm is reported as follows:

Selling price	$240,000
Minus: Installment basis	148,250
Gross profit	$ 91,750
Gain reported in 1990, year of sale	$ 27,525
Gain reported in 1991, $38,000 × 48.2895%	18,350
Gain reported in 1992, $38,000 × 48.2895%	18,350
Gain reported in 1993, $38,000 × 48.2895%	18,350
Gain reported in 1994, $19,000 × 48.2895%	9,175
	$ 91,750

13. Casualties, Thefts, and Condemnations

When property is damaged or destroyed by hurricane, earthquake, tornado, fire, vandalism, auto or truck accident, flood, etc., such an event is called a ***casualty.*** A casualty may result in a deductible loss on your federal income tax return. If your property is stolen, you may have a deductible ***theft*** loss.

The lawful taking of your property, without your consent, for public use by the federal government, a state government, or a political subdivision is a ***condemnation*** that can result in a gain or a loss. For more information on condemnation, see Publication 544, *Sales and Other Dispositions of Assets.*

Casualties, thefts, and condemnations are called ***involuntary conversions.*** This chapter explains how to report the gains and losses that may result from involuntary conversions of property.

Casualties and Thefts

If your property is destroyed, damaged, or stolen, you may have a deductible loss. If the insurance or other reimbursement is more than the adjusted basis of the destroyed, damaged, or stolen property, you may have a gain.

Casualty. A casualty loss must result from an identifiable event that is sudden, unexpected, or unusual. Deductible casualty losses may result from a number of different causes, including:

1) Fire, flood, storm, lightning, freezing, earthquake, shipwreck, airplane crash, hurricane, and similar occurrences, and
2) Auto or truck accidents not resulting from your willful act or negligence.

Damage from a normal process or from ***progressive deterioration*** of property through a steadily operating cause, such as the steady weakening of a foundation from wind and weather, or the infestation of termites, is not a casualty loss.

Losses on deposits in insolvent or bankrupt financial institutions. If you have a loss from a deposit in a bank, credit union, or other financial institution because the institution became insolvent or bankrupt, you may choose to treat the loss as a casualty loss.

Theft. A theft is the unlawful taking and removing of your money or property with the intent to deprive you of it. It includes larceny, robbery, and embezzlement. Misrepresentation, however, is not a theft.

Example. You purchased a farm. The seller assured you that a water well produced an adequate supply of water, but the well went dry after you took possession. You do not have a deductible theft loss because of the seller's misrepresentation.

Farming losses. Certain casualty or theft losses that occur in the business of farming are deductible losses. The following is a discussion of some losses that may be deducted and some that may not.

Livestock or produce purchased for sale. Losses of livestock or produce purchased for sale are deductible if you report your income on the cash method. If you report on the accrual method, casualty and theft losses of property raised or purchased for sale are taken by omitting the item from the closing inventory for the year of the loss. A separate deduction is not allowed.

Livestock, produce, and crops raised for sale. Losses of livestock, produce, and crops raised for sale (including harvested and unharvested crops) are not deductible if you report on the cash method because the value of the items has not been included in income. If you report on the accrual method, a casualty or theft loss is deductible only if you included the items in your inventory at the beginning of your tax year. You get the deduction by omitting the item from your inventory at the close of your tax year. You are not allowed a separate deduction.

Damage to crops. Damage to crops, whether or not covered by insurance, are not deductible losses. These damages are losses of anticipated income. The costs of raising the damaged crops are deductible as business expenses.

Losses from death of tree seedlings. If, because of an abnormal drought, the failure of planted tree seedlings is greater than normally anticipated, you may have a deductible casualty loss. The loss is equal to the previously capitalized reforestation costs that had to be duplicated on replanting, and is allowed for the year in which the seedlings died.

Property used in farming. Casualty and theft losses of property used in the farming business usually result in deductible losses. If your barn was destroyed by fire or storm, or if an animal you purchased for draft, breeding, dairy, or sport was lost by casualty or theft, you may have a deductible loss. See *How to figure a loss,* discussed later.

Raised draft, breeding, dairy, or sporting animals. Losses of raised draft, breeding, dairy, or sporting animals do not result in deductible casualty or theft losses unless you use inventories to determine your income and the animals have been included in your inventory. The cost of raising the livestock has been deducted, and if inventories are not used, the livestock has no cost or other basis for income tax purposes.

However, if you did not elect out of the capitalization rules, you may still have a tax basis in the livestock.

When livestock is included in inventory, its last inventory value is its basis. This is true of both raised and purchased animals that are inventoried. When an inventoried animal held for draft, breeding, dairy, or sport is lost by casualty or theft, you must decrease your inventory at the beginning of the year by the value at which the animal was included in inventory. This inventory value, being the basis of the animal, must then be used to determine the amount of your gain or loss.

Other losses. The deductibility of losses resulting from a casualty or theft to your personal-use property, a casualty in a disaster area, and other related items are discussed next.

Property held for personal use. Casualty and theft losses of property held for personal use are deductible on your federal income tax return. Examples of these losses are fire damage to your personal residence, furniture, automobile, clothing, or other personal property, and storm losses of trees and shrubbery, including those used for ornamental purposes. Losses by theft may also be deducted.

A casualty or theft loss is generally one of the following amounts, whichever is less:

1) The decrease in the fair market value of the property as a result of the casualty or theft, or
2) Your adjusted basis in the property before the casualty or theft.

The decrease in fair market value is the difference between the property's value immediately before the casualty or theft and its value immediately afterwards. Fair market value is defined in Chapter 12. Basis is the measurement, for tax purposes, of your investment in the property. Basis is discussed in Chapter 7. However, there are two rules, discussed next, that apply to casualty or theft losses of personal-use property that do not apply to business or other income-producing property.

$100 rule. You may not deduct the first $100 of loss from a casualty or theft of property held for personal use. This $100 rule applies after you have subtracted any reimbursement, and applies to ***each*** casualty or theft occurrence during your tax year.

10% rule. You may deduct nonbusiness casualty or theft losses only if your total losses during the year are greater than 10% of your adjusted gross income (line 31, Form 1040). You still must reduce each separate casualty or theft loss by $100.

Example. In June 1990 you discovered that your house was burglarized. This was your only casualty or theft loss during 1990. Your theft loss after insurance reimbursement was $2,000. Your adjusted gross income for 1990 was $29,500. To figure your deduction, you first apply the $100 rule and then the 10% rule. Your loss after applying the $100 rule is $1,900 ($2,000 − $100). When you apply the 10% rule, you find you do not have a casualty or theft loss deduction because your loss ($1,900) is less than 10% of your adjusted gross income ($2,950).

Note. If you have a nonbusiness casualty or theft gain in addition to a loss, you will have to make a special computation to figure your 10% limit. See Publication 547, *Nonbusiness Disasters, Casualties, and Thefts.*

Items not included with deductible losses. The following are not deductible as casualty or theft losses:

1) Expenses related to a casualty or theft, such as temporary housing or car rental, lights and fuel, or moving expenses. (However, if the expense is in connection with your business, it may be a deductible business expense.)
2) Cost of repairing, replacing, or cleaning up after a casualty. See *Repair costs,* discussed later.
3) Expenses because of injury to yourself or other persons.
4) Loss of mislaid cash or property.
5) Damage by rust or erosion.

How to figure a loss. The amount of a casualty loss of farm business property that is ***partly*** destroyed is the decrease in the fair market value of your property or the adjusted basis of your property, whichever is less. It must also be reduced by any insurance or other reimbursement you receive or expect to receive. The amount of loss is figured as follows:

1) Determine the difference between the fair market value of the property immediately before the casualty and the fair market value immediately after the casualty. Fair market value is explained in Chapter 12.
2) If the amount in (1) is less than the adjusted basis of your property at the time of the casualty, subtract any insurance or other reimbursement from that amount, and the balance is your casualty loss. See Chapter 7 for an explanation of adjusted basis.
3) If, however, the amount in (1) is more than the adjusted basis of your property, subtract the insurance or other reimbursement from your adjusted basis, and the balance is your casualty loss.

If your business property is ***completely*** destroyed or stolen, your casualty loss is the adjusted basis of your property minus any salvage, insurance, or other reimbursement you receive or expect to receive. This is true even though the fair market value of your property before the loss was less than its adjusted basis.

Example. A fire on your farm damaged a tractor and the barn where the tractor was stored. The tractor had an adjusted basis of $3,300, and was worth $2,800 just before the fire and $1,000 immediately afterward. The barn had an adjusted basis of $8,000, and was worth $25,000 just before the fire and $15,000 immediately afterward. You received insurance of $600 on the tractor and $6,000 on the barn. Your deductible casualty loss must be figured separately for the two items of property.

	Tractor	Barn
1) Adjusted basis	$3,300	$ 8,000
2) Value before fire	$2,800	$25,000
3) Value after fire	1,000	15,000
4) Decrease in value (2 minus 3)	$1,800	$10,000
5) Amount of loss (1 or 4, whichever is less)	$1,800	$ 8,000
6) Minus: Insurance	600	6,000
7) ***Deductible casualty loss***	$1,200	$ 2,000

Because these assets were only partly destroyed, the lower of adjusted basis or the decrease in value for the tractor and barn is the amount used before the adjustment for insurance. For the partial or complete destruction of crops or livestock, the loss would have been figured the same way as it was figured for your farm bus
property, but only if it is a deductible loss.

Separate losses. When a loss occurs to f
property, a separate computation must be ma
for each identifiable item of property. If damag
occurs to a farm building and to an orchard, b
of which are a part of the same realty, the los
value must be measured by taking each into
account separately.

Real property and personal-use improvements. In figuring the loss to real pr
erty and improvements used in a nonbusines
way, the improvements, such as buildings and
ornamental trees, are considered a part of the
property, and only a single loss for the one pr
erty is computed.

Example. You bought a farm in 1951 for
$20,000. The adjusted basis of the residential
is $6,000. In 1990 a windstorm blew down sh
trees and three ornamental trees planted at a
of $600 on the residential part. The fair mark
value of the residential part immediately befo
the storm was $30,000, and $26,000 immedi
after the storm. Your adjusted gross income f
1990 is $20,000. You were not covered by ins
ance for this loss.

1) Adjusted basis	$
2) Value before the storm	$3
3) Value after the storm	2
4) Decrease in value (2 minus 3)	$
5) Amount of loss (1 or 4, whichever is less)	$
6) Minus: Insurance	
7) Loss after reimbursement	$
8) Minus: $100	
9) Loss after $100 rule	$
10) Minus: 10% of $20,000	
11) ***Deductible loss***	$

Repair costs. You may use the cost of cl
ing up and making repairs after a casualty as
measure of the decrease in value of the prop
if:

1) They are needed to restore the property
condition before the casualty,
2) The cost of repairs is not excessive,
3) They do no more than take care of the d
age, and
4) The value of the property after repairs is
as a result of the repairs, more than its v
before the casualty.

The cost of debris removal may be used, lik
cost of repairs, as evidence of the amount o
casualty loss if these conditions are satisfied

Adjustments to basis. If your property i
partly or totally destroyed by casualty and yo
compensated for the loss by insurance or ot
reimbursement, you must decrease the basis
the property by the insurance or other reimb
ment you received. The insurance or reimbu
ment represents a return of part or all the ca
you invested in the property.

If a casualty to property results in a deduc
loss, in addition to decreasing its basis by th
insurance, you must also decrease the basis
the deductible loss. You increase the basis
amounts spent to rebuild the property.

When loss is deductible. Casualty losses
erally are deductible only in the year in which
occur. Theft losses generally are deductible
in the year in which they are discovered.

Leased property. If you lease property,
may deduct a loss on the property in the ye
liability is fixed, not the year it is paid. You a
entitled to a deduction until your liability und
lease is "ascertainable with reasonable acc
racy."

Netoperating loss (NOL). If your deductions, including casualty or theft loss deductions, are more than your income for the year, you may have an NOL. An NOL may be carried back or carried forward and deducted from income in other years. For information on NOLs, see Publication 536, *Net Operating Losses.*

Reimbursements. If you have a reasonable prospect of being reimbursed for part or all of your loss, you must subtract the expected reimbursement to figure your loss. You must reduce your loss even if you do not receive payment until a later tax year. If you later receive less than the amount you expected, you may deduct the difference when you determine that you cannot reasonably expect any more reimbursement. .

Example. Your personal car had a fair market value of $2,000 when it was completely destroyed in a collision with another car in 1989. The accident was due to the negligence of the other driver. At the end of the year, there was a reasonable prospect that you would recover the total damages from the owner of the other car. You do not have a deductible loss for 1989. In January 1990 the court awards you a judgment of $2,000. In July 1990 you can show with reasonable certainty that the other driver is totally without funds. You may claim a loss in 1990 of the amount that is more than $100 and 10% of your 1990 adjusted gross income.

Reimbursement in a later year. If you later receive more reimbursement than you expected after claiming a deduction for the loss, you must include the extra reimbursement in your income in the year you receive it. However, if any part of the original deduction did not reduce your tax for the earlier year, do not include the extra reimbursement for that part of your deduction. You do not refigure your tax for the year you claimed the deduction.

Disaster area losses. If you have a deductible loss from a disaster that occurred in an area determined by the President of the United States to be eligible for federal disaster assistance, you may choose to deduct that loss on your return for the immediately ***preceding tax year.*** If you make this choice, this loss will be considered as having occurred in the preceding year.

Proof of loss. To take a deduction for a casualty or theft loss, you must be able to show that there was actually a casualty or theft, and be able to support the amount you take as a deduction.

For a ***casualty,*** you should be able to show:

1) The type of casualty (car accident, fire, storm, etc.) and when it occurred,
2) That the loss was the direct result of the casualty, and
3) That you were the owner of the property or, if you leased the property from someone else, that you were liable, under a contract, to the owner for the damages.

For a ***theft,*** you should be able to show:

1) When you found that your property was missing,
2) That your property was stolen, and
3) That you were the owner of the property.

Other Involuntary Conversions

In addition to casualties and thefts, there are other events that bring about involuntary conversions of property. Some of these events are described in the following paragraphs. For information on how to treat a gain or a loss due to these events, see *How To Figure Gain or Loss,* later.

Condemnation. Condemnation is the process by which private property is legally taken, without the owner's consent, for public use. The property may be taken by the federal government, a state government, a political subdivision, or a private organization that has the power to legally take the property. The owner receives money or property in exchange for the property.

Threat of condemnation. The sale of your property under threat of condemnation is treated in the same manner as a condemnation.

Personal residence. You may choose to treat the condemnation of your personal residence either as an involuntary conversion (a forced sale) or a voluntary sale. See Chapter 10.

For more information on condemnations, see Publication 544.

Irrigation project. Property located within an irrigation project that is sold or otherwise disposed of to conform to the acreage limits of federal reclamation laws is a condemnation.

Diseased livestock. If livestock die from disease, are destroyed because of disease, or are sold or exchanged because of disease, even though the disease is not of epidemic proportions, such occurrences are treated as involuntary conversions.

Drought sales of livestock. When livestock (other than poultry) held for draft, breeding, or dairy purposes are sold or exchanged solely because of drought, their disposition is treated as an involuntary conversion. Only livestock sold in excess of the number you normally would sell under usual business practice, in the absence of drought, are considered involuntary conversions. For example, if under usual business practice you normally would sell five of your dairy animals during the year, but because of drought you sold 20 dairy animals, the gain from 15 of them would be a gain due to an involuntary conversion.

Poultry or livestock. You cannot use involuntary conversion treatment for poultry or livestock that are held for reasons other than draft, breeding, or dairy purposes. In these cases, any gain realized generally must be included in income in the year it is realized. However, see *Drought Sales* in Chapter 4 for a discussion of the special elections to include income in a year other than the year in which it is realized.

How To Figure Gain or Loss

You have a gain from a casualty or theft if your reimbursement is more than the adjusted basis of the damaged, destroyed, or stolen property. The amount of your gain is reduced by your expenses in obtaining the reimbursements. However, you may postpone reporting the gain if you acquire qualified replacement property, as explained later. You have a loss if your reimbursement is less than the adjusted basis of the property.

If you have business or income-producing property that is completely lost because of a casualty or theft, your deductible loss is your adjusted basis in the property minus any salvage value and any insurance or other reimbursement. The decrease in the fair market value does not matter.

Lump-sum reimbursement. If you have a casualty or theft loss of several assets at the same time, you must divide the lump-sum reimbursement among the assets according to the fair market value of each of the assets at the time of the loss. You must figure the gain or loss separately for each asset that has a separate basis.

Postponement of Gain

You can choose to postpone reporting the gain if you acquire replacement property that is similar or related in service or use to your original property within a specific replacement period.

To postpone all the gain, the cost of your replacement property must be at least as much as the reimbursement you receive. If the cost of the replacement property is less than the reimbursement, you must include the gain in your income up to the amount of the unspent reimbursement.

Replacement Property

You must buy replacement property for the specific purpose of replacing your property. Your replacement property must be similar or related in service or use to the property it replaces. You do not have to use the insurance money from your old property to acquire the replacement property. Property or stock you acquire by gift or inheritance does not qualify as replacement property.

Soil or environmental contamination. If, because of soil or environmental contamination, it is not practical for you to reinvest your insurance money from destroyed livestock in property similar or related in service or use to the livestock, other property, including real property used for farming purposes, will be treated as property similar or related in service or use to the destroyed livestock.

Standing crop destroyed by casualty. If your standing crop is destroyed by a storm or other casualty and the insurance money is used to acquire either another standing crop or a harvested crop, this purchase qualifies as replacement property. The cost of planting a new crop, however, does not qualify as a replacement for the destroyed crop.

Making the replacement. You must buy replacement property for the specific purpose of replacing your condemned, damaged, destroyed or stolen property. You do not have to use the actual award or reimbursement from your old property to acquire the replacement property. If you spend the money you receive from the insurance company for other purposes and borrow money to buy replacement property, you can still choose to postpone the gain if you meet the other requirements.

The proceeds from the sale of timber downed as a consequence of a casualty (such as high winds, earthquakes, or volcanic eruptions) may be treated as a reimbursement, and qualify for postponement of gain if they are invested in other property similar or related in service or use to the property converted within the specified replacement period.

Replacement Period

To postpone reporting your gain from a casualty or theft, you must buy replacement property within a specified period of time. This is the replacement period.

The ***replacement period begins*** on the date your property was damaged, destroyed, or stolen.

The ***replacement period ends*** 2 years after the close of the first year in which any part of your gain from the casualty or theft is realized.

Extension. You may get an extension of the replacement period if you apply to the District Director of the Internal Revenue Service for your area. You should apply before the end of the replacement period. Your application should contain all the details about the need for your extension. You may file an application within a reasonable time after the replacement period ends if you can show a good reason for the delay. Extension of time will be granted if you can show reasonable cause for not making the replacement within the regular period.

How to postpone the gain. You should report your election to postpone your gain, along with all the necessary details, on the return for the tax year in which you realize the gain.

Replacement property acquired before return filed. If you acquire replacement property before you file your return for the year in which the gain is realized, you must attach a statement to your return. The statement should show the amount realized from the casualty or theft, how you figured the gain, and the amount of gain you are reporting as income.

Replacement property acquired after return filed. If you intend to buy replacement property after you file your return for the year in which you have the gain, attach a statement to your return. The statement should give all the facts relating to the casualty or theft. It should also show how you figured the gain, and should say that you choose to replace the property within the required replacement period.

You then attach another statement to your return for the year in which you buy the replacement property. This statement should contain detailed information on the replacement property. If you acquire part of your replacement property in one year and part in another year, you must make a statement for each year. The statement should contain detailed information on the replacement property bought in that year.

Substituting replacement property. Once you have acquired replacement property that you designate as replacement property, you may not later substitute other qualified replacement property. This is true even if you do it within the replacement period. The designation is made by the statement with your return reporting that you have acquired replacement property. However, if after you replace the property you discover that it is not qualified replacement property, you may, within the replacement period, substitute the new qualified replacement property.

Taxpayer's death. If a taxpayer dies in the year the gain is realized, but before replacement property is acquired, there can be no election to postpone the gain. Instead, the gain must be reported on the decedent's final income tax return.

Amended return. You must file an amended return for the tax year in which the gain was realized if you made the election to postpone tax on the gain and later did not acquire replacement property within the replacement period, or the replacement property costs less than anticipated at the time you made the election.

Reporting Gains and Losses

Form 4684, *Casualties and Thefts,* is used to figure your gains and losses from casualties and thefts. Carry your gains and losses from business property or property held for investment to ***Form 4797,*** *Sales of Business Property.* Your gains from personal-use property are reported on ***Schedule D*** (Form 1040). Your losses from nonbusiness property are reported on line 18 of ***Schedule A*** (Form 1040).

Losses resulting from casualty or theft of livestock or produce bought for sale may be deducted under *Other expenses* in Part II, line 34 of ***Schedule F*** (Form 1040) by farmers filing on the cash method, if such losses have not been otherwise accounted for.

Reporting drought sales of livestock. When livestock held for draft, breeding, or dairy purposes are sold or exchanged because of drought and you choose to postpone the gain, your return for the tax year in which you first realize any of the gain should contain the following information:

1) Evidence of the drought conditions that forced the sale or exchange of the livestock,
2) The gain realized on the sale or exchange,
3) Number and kind of livestock sold or exchanged, and
4) Number of livestock of each kind that you would have sold or exchanged under your usual business practice in the absence of the drought.

The return for the year in which the livestock are replaced should contain information showing:

1) Date replacement livestock was purchased,
2) Cost of the replacement livestock, and
3) Number and kind of the replacement livestock.

14. Alternative Minimum Tax

Important Change for 1990

Intangible drilling and development costs. For tax years beginning after 1989, you can choose to write off intangible drilling and development costs over a 60–month period. See *60–month write-off,* later, under *Optional Write-Off.*

The tax laws give special treatment to some kinds of income and allow special deductions and credits for some kinds of expenses. Taxpayers who benefit from these laws have to pay at least a minimum amount of tax through an additional tax—the "alternative minimum tax" for individuals and corporations.

You may have to pay the alternative minimum tax if your taxable income for regular tax purposes, combined with any of the adjustments and preference items that apply to you, totals more than:

1) $40,000 if you are married filing a joint return (or a qualifying widow(er)),
2) $30,000 if your filing status is single or head of household, or
3) $20,000 if your filing status is married filing a separate return.

Adjustments to taxable income include:

1) Addition of personal exemptions,
2) Addition of the standard deduction (if claimed),
3) Addition of itemized deductions claimed for state and local taxes, certain interest, most miscellaneous deductions, and part of medical expenses,
4) Subtraction of any refund of state and local taxes included in gross income,
5) Change in amount of depreciation claimed on certain property,
6) Change in method of determining income from long-term contracts entered into on or after March 1, 1986,
7) Change in method of determining income from certain installment sales,
8) Change in method of determining net op ing loss deduction, and
9) Change in method of determining passive activity loss deduction.

Tax preference items include:

1) That part of any deduction for depletion th more than the adjusted basis of the proper
2) Part of any deduction for intangible drilling costs if the deduction (minus the amount th could have been deducted if the cost were amortized over 120 months) is more than 65% of the net income from oil, gas, and g thermal properties,
3) Tax-exempt interest on certain private acti bonds,
4) Unrealized appreciation on donated long-te capital gain property, and
5) Accelerated depreciation on certain proper placed in service before 1987.

This chapter is a guide to help taxpayers wh must pay the alternative minimum tax. To find whether you will owe this tax, refer to the requi ments explained in this chapter and complete **Form 6251,** *Alternative Minimum Tax — Indivi als.* Any alternative minimum tax you owe is ad to the tax on your Form 1040. (You will need to complete lines 1 – 43 of Form 1040 before you can complete Form 6251.)

The rules discussed in this chapter apply to viduals. Estates and trusts should see the instructions for **Form 8656,** *Alternative Minimu Tax — Fiduciaries.*

The alternative minimum tax that applies to porations is discussed in Publication 542, *Tax Information on Corporations.* Corporations use **Form 4626,** *Alternative Minimum Tax — Corporations.*

Outline for figuring the tax. Each step belo explained in more detail later in this chapter. F ure the alternative minimum tax as follows.

Begin with
Taxable income on return (line 37, Form 1040)
add or subtract
Adjustments to taxable income
add
Tax preferences
equals
Alternative minimum taxable income
subtract
Exemption amount
multiply by
21%
subtract
Foreign tax credit
equals
Tentative minimum tax
subtract
Regular tax
equals
Alternative minimum tax.

Estimated tax. When you figure your estim tax for 1991, you must include any alternative imum tax you expect to have to pay in 1991. Publication 505, *Tax Withholding and Estima Tax,* for more information about estimated ta

Do You Owe Alternative Minimu Tax (AMT)?

You may have to pay the alternative minimu (AMT) if your taxable income for regular tax purposes, plus or minus any of the adjustme and preference items (including adjustments to the net operating loss deduction), totals more than:

- $40,000 if married filing a joint return (or a qualifying widow(er)),
- $30,000 if single or head of household, or
- $20,000 if married filing a separate return.

The adjustments and preference items that may apply to you are listed below. The column titled "Description" provides a brief explanation of how to treat these items for AMT purposes. Each adjustment and preference is also explained separately in the next major discussion.

Adjustments	Description
Standard deduction	No deduction allowed
Personal exemptions	No deduction allowed
Itemized deductions	Itemized deductions for taxes, personal interest, and most miscellaneous deductions not allowed; those for other interest and medical expenses restricted
Accelerated depreciation on new property	Depreciation used for AMT is figured under the alternate method of the modified accelerated cost recovery system (MACRS) except that for personal property the 150% declining balance method is used
Circulation expenditures	Expenditures must be amortized ratably over 3 years
Research and experimental expenditures	Expenditures must be amortized ratably over 10 years
Mining exploration and development costs	Allowable costs must be amortized ratably over 10 years
Long-term contracts	For contracts entered into after February 28, 1986, figure income under the percentage of completion method
Pollution control facilities	Amortization figured under alternate MACRS
Certain installment sales	Installment method generally does not apply for AMT
Certain incentive stock options	Excess of fair market value over option price at date of exercise
Passive activity losses	Net losses from passive activities, including tax shelter farm activities, not allowed
Distributions from estates and trusts	Beneficiaries include their share of Distributive Net Alternative Minimum Taxable Income for AMT purposes instead of the income reported for regular tax purposes
Alternative tax net operating loss	NOLs allowed with certain adjustments.

Tax Preferences	Description
Appreciated property charitable deduction	Unrealized appreciation on donated long-term capital gain property
Certain tax-exempt interest	Certain interest on specified private activity bonds
Depletion	Excess of depletion deduction over adjusted basis in property
Accelerated depreciation on depreciable real property and depreciable leased personal property placed in service before 1987 (pre-MACRS property)	Excess of depreciation or amortization taken over straight line deduction
Intangible drilling costs	Excess of deducted costs over the total of the amount allowable if costs were amortized ratably over 120 months plus 65% of net income from the properties.

Partner, beneficiary, or shareholder. You may also have to pay AMT if you are a partner in a partnership, a beneficiary of an estate or trust, or a shareholder in an S corporation.

Partner. If you are a partner, you must include your distributive share of the partnership's adjustments and tax preference items in figuring your AMT. These will be furnished to you on Schedule K–1 (Form 1065). The partnership itself does not pay AMT.

Beneficiary. Each beneficiary of an estate or trust must include his or her share of distributable net AMT taxable income. This will be shown on Schedule K–1 (Form 1041). See *Beneficiaries of estates and trusts*, later, under *Adjustments*. The estate or trust must pay AMT on any remaining AMT taxable income.

S corporation shareholder. Each shareholder in an S corporation must include his or her share of the corporation's adjustments and tax preference items. These will be furnished on Schedule K–1 (Form 1120–S).

Form 6251. To see if you owe AMT, use Form 6251, *Alternative Minimum Tax—Individuals.* Estates and trusts must use Form 8656, *Alternative Minimum Tax—Fiduciaries.*

AMT Taxable Income

To figure AMT, you must first arrive at AMT taxable income. Begin with the taxable income shown on your tax return (line 37, Form 1040). This figure may be negative. If you have a net operating loss (NOL) deduction, add it to your taxable income. Combine this figure with the adjustments discussed next and the preference items discussed later. If you have an NOL deduction, you will have to refigure your NOL and subtract the refigured amount (subject to a limit). The result is your AMT taxable income.

Adjustments

To figure AMT taxable income, you must make certain adjustments to the taxable income shown on your return These adjustments are designed to eliminate the tax advantages of items that receive special tax treatment. The amount of the adjustment is generally the difference between a recomputed amount and the amount shown on the return. Adjustments can be either increases or decreases.

Note. If you have a net operating loss, you must recompute it to figure your AMT taxable income. However, you cannot recompute it until you have completed your other adjustments and added back your preference items. See *Alternative Tax Net Operating Loss (NOL) Deduction*, later.

Standard deduction. You cannot claim the standard deduction in figuring your AMT taxable income. If you claimed the standard deduction in figuring your regular tax, add that amount back to the taxable income on your return.

Personal exemptions. You cannot deduct personal exemptions in figuring your AMT taxable income. If you claimed an amount for exemptions in figuring your regular tax, add that amount back to the taxable income on your return.

Itemized deductions. To figure AMT taxable income, you must make the following adjustments to your regular taxable income.

Medical expenses. For AMT purposes, you are allowed to deduct your medical expenses in excess of 10% of your adjusted gross income (AGI). For regular tax purposes, you can deduct your medical expenses in excess of 7.5% of your AGI. Therefore, you increase the taxable income on your return by the smaller of 2.5% of your AGI (line 32, Form 1040) or the amount deducted for regular tax purposes on line 4 of Schedule A (Form 1040).

Miscellaneous itemized deductions. For AMT purposes, you are not allowed to deduct any of your miscellaneous itemized deductions that are subject to the 2% limit. You must add back any deduction on line 25, Schedule A (Form 1040).

Taxes. You cannot deduct state, local, or foreign income taxes, real property taxes, or state or local personal property taxes in figuring AMT taxable income. You must add to your regular taxable income the amount deducted on line 8, Schedule A (Form 1040).

Note. Do not include refunds of these taxes deducted on a prior year's return in your AMT taxable income. Use line 4f of Form 6251 to subtract these refunds from your regular taxable income.

Personal interest. You are not allowed a deduction for personal interest expense in figuring your AMT taxable income. Add back to your regular taxable income any amount deducted on line 12b, Schedule A (Form 1040).

Other interest. You may have to make two other adjustments based on deductible interest expense.

1) Home mortgage interest. You must increase your regular taxable income by the amount of home mortgage interest you deducted on Schedule A (Form 1040) that is for a mortgage:

- Taken out after June 30, 1982, that you did not use to purchase, build, or substantially rehabilitate your main home or qualified dwelling, or
- Taken out before July 1, 1982, that was not secured by property that was your main home or a qualified dwelling used by you or a member of your family. (A qualified dwelling is any house, apartment, condominium, or mobile home not used on a transient basis.)

If you refinanced your mortgage after June 30, 1982, for an amount in excess of your original mortgage, you cannot deduct the interest related to the excess.

Add back to your regular taxable income the total of these home mortgage interest items.

2) Investment interest. For AMT purposes, you can deduct investment interest expense only up to the amount of your investment income. Include in investment income interest on tax-exempt "private activity" bonds (see later discussion under *Tax Preference Items*). Include in investment interest expense any interest expense incurred in carrying the bonds.

Note that for regular income tax purposes you can deduct 10% of the investment interest expense that exceeds (up to certain amounts) investment interest income. This is not allowed for AMT purposes.

For AMT purposes, figure your investment interest deduction on a separate Form 4952, *Investment Interest Expense Deduction*, following the instructions for Form 6251. The difference between that amount and the deduction you figured for regular tax purposes is your adjustment.

See Publication 550, *Investment Income and Expenses*, for more information on figuring the investment interest deduction for regular income tax purposes.

Accelerated depreciation. For certain property placed in service before 1987, accelerated depreciation is a tax preference item. Continue to treat depreciation on that property as a preference item. See *Accelerated depreciation on real property placed in service before 1987* and *Accelerated depreciation on leased personal property placed in service before 1987* under *Tax Preference Items*, later.

Tangible property placed in service after 1986. For AMT purposes, you must recompute your depreciation deduction using the alternative depreciation system (ADS) of the modified accelerated cost recovery system (MACRS). Use the 150% declining balance method (switching to straight line in the first tax year that method gives a better result) over the class life of the property for tangible property other than:

- Real property, and
- Tangible property on which you used the straight line method.

Use the same convention you used for regular tax purposes.

For residential rental and nonresidential real property, use the straight line method over 40 years. Use the same mid-month convention you used for regular tax purposes.

In applying these rules, the "class life" you use for AMT purposes has a different meaning than the recovery period you used for regular tax purposes. The class lives you need to use for AMT can be found in Publication 534, *Depreciation*. Use 12 years for any personal property that does not have an assigned class life. Publication 534 also contains percentage tables that can be used in computing depreciation for AMT purposes.

You must make this adjustment for any real and personal property placed in service:

- After 1986 (other than transition property),
- After July 31, 1986, ***and*** before 1987 if you elected MACRS for this property.

Your adjustment is the difference between the depreciation you recomputed for AMT purposes and the depreciation you took on that same property for regular tax purposes.

There is no difference between depreciation for AMT purposes and for regular tax purposes for the following property:

- Property you elect to exclude from MACRS that is depreciated under the unit-of-production method or most other methods of depreciation not expressed in terms of years,
- Certain public utility property,
- Any motion picture film or video tape, or
- Any sound recording.

If the recomputed depreciation is less than the depreciation you took for regular tax purposes, add the difference to your regular taxable income. If the recomputed depreciation is greater than the depreciation you took for regular tax purposes, subtract the difference from your regular taxable income.

The effect of using two different types of depreciation (one for regular income tax and one for AMT) is that you will have a different basis in the property for AMT. This means, for example, should you sell the property, the gain will be different for AMT purposes. See *Adjusted gain or loss*, later.

For more information on depreciation, see Chapter 8.

Circulation expenditures. For AMT purposes, circulation expenditures must be amortized over 3 years beginning with the tax year in which the expenditures were made. If the recomputed amount of circulation expenditures is less than the deduction you took for regular tax purposes, add the difference to your regular taxable income. If the recomputed amount is greater than the deduction you took for regular tax purposes, subtract the difference from your regular taxable income.

Research and experimental expenditures. For AMT purposes, research and experimental expenditures must be amortized over 10 years beginning with the tax year in which the expenditures were made. If the recomputed amount of research and experimental expenditures is less than the deduction you took for regular tax purposes, add the difference to your regular taxable income. If the recomputed amount is greater than the deduction you took for regular tax purposes, subtract the difference from your regular taxable income.

Note. If you have a loss on property on which you took a deduction for circulation or research and experimental expenditures for regular tax purposes, you may have an adjustment for AMT purposes. Subtract from your regular taxable income the smaller of:

1) The amount of the loss reduced by any reimbursement you received, or
2) The remaining costs to be amortized for AMT purposes.

Mining exploration and development costs. This deduction is computed by taking the amount you are allowed as a deduction for regular tax purposes for mining exploration and development costs paid or incurred after 1986 and amortizing this amount over a 10-year period. If the recomputed amount of these costs is less than the deduction you took for regular tax purposes, add the difference to your regular taxable income. If the recomputed amount is greater than the deduction you took for regular tax purposes, subtract the difference from your regular taxable income.

If you have a loss because mining property is abandoned as worthless, a special rule applies when you figure AMT taxable income. Subtract from your regular taxable income all mining exploration and development costs from the property that you have not yet written off under the AMT.

Long-term contracts. Generally, for any long-term contracts you entered into after February 28, 1986, you are required to use the percentage of completion method of accounting to figure AMT taxable income relating to that contract.

If the long-term contract is a construction contract, you generally must figure AMT taxable income using the simplified method for allocating costs if:

1) You estimate that the contract will be completed within 2 years of the contract starting date, and
2) Your average annual gross receipts for the 3 tax years preceding the tax year in which you entered into the contract are not more than $10,000,000.

Exception. If the long-term contract is a construction contract entered into after June 20, 1988, and you meet requirements (1) and (2) above, you do not need to use the percentage of completion method to figure your AMT taxable income relating to that contract.

Note. Regardless of whether you meet ments (1) and (2) above, if your contract is construction contract that you entered into year beginning after September 30, 1990, not need to use the percentage of complet method to figure your AMT taxable income relating to that contract.

Making the adjustment. Subtract the you reported for regular tax purposes from income you recomputed for AMT purposes enter the result on Form 6251.

If the amount reportable for AMT purpos less than that reported for regular tax purp enter the difference as a negative amount Form 6251.

Amortization of certified pollution cont facilities. For AMT purposes, your amort deduction for a certified pollution control f placed in service after 1986 is determined the alternate MACRS rules (see Publicatio If the amount you recomputed using alter MACRS is less than the amount you dedu regular tax purposes, add the difference t regular taxable income. If the recomputed is greater than the amount you deducted lar tax purposes, subtract the difference fr regular taxable income. Also, see *Amortiz certified pollution control facilities placed service before 1987*, discussed later unde *Preference Items*.

Installment sales of certain property. disposed of inventory after March 1, 1986 generally cannot use the installment meth accounting to determine your income for purposes.

Dealer dispositions. For dealer dispo occurring after March 1, 1986, but before you must make an adjustment if you used installment method for regular tax purpos were required to report the entire gain in of disposition for AMT purposes. Enter in you reported for these dispositions for reg purposes this year as a negative amount 6251.

For dealer dispositions after 1987, you will not have to make an adjustment. Thi because you generally cannot use the in method for either regular tax purposes or purposes.

Nondealer dispositions. For nondea sitions occurring after March 1, 1986, but the first day of your tax year which began you must make an adjustment if you use installment method for regular tax purpos were required to report the entire gain in of disposition for AMT purposes. Enter in you reported for these dispositions for re purposes this year as a negative amount 6251.

For nondealer dispositions on or after day of your tax year which began in 1987 generally will not have to make an adjust This is because you generally cannot us installment method for either regular tax or AMT purposes.

Adjusted gain or loss. If you sold prop during the year, you must refigure your g from the sale using your adjusted basis f purposes. You must make changes to yo tax basis for the following AMT adjustme

- Depreciation,
- Circulation expenditures,
- Research and experimental expenditu
- Mining exploration and development c
- Pollution control facilities.

Enter on line 4p of Form 6251, the differ between the gain (or loss) shown on you for regular tax purposes and the gain (o ured using your AMT adjusted basis.

Incentive stock options. For AMT purposes, you must treat stock acquired through the exercise of an incentive stock option differently than for regular tax purposes. If this stock was acquired after 1987, the adjustment is the excess (if any) of the stock's fair market value at the time of exercise over the amount you paid for the stock.

You are to make this adjustment in the first taxable year in which your rights in the stock are freely transferable or are not subject to a substantial risk of forfeiture.

Disposition in same year. There is no adjustment if:

- You exercise and dispose of a stock option in the same year, and
- The amount you realize on the disposition is less than the value of the option at the time it was exercised.

In that case, the AMT and regular tax treatments are the same. Thus, the AMT adjustment will not exceed the gain on the disposition of the stock.

Certain loss limitations. You must consider your AMT adjustments and preferences before you apply certain loss deferral rules.

The loss deferral rules include limits on losses based on:

- A partner's basis in the partnership interest,
- A shareholder's basis in the S corporation stock and indebtedness, and
- The at-risk limits.

The adjustment is the difference between the allowable loss reported for regular tax purposes and the amount of your recomputed allowable loss. This figure could be negative if the recomputed allowable loss is more than the allowable loss reported for regular tax purposes.

Tax shelter farm loss. In figuring AMT taxable income, no loss from a tax shelter farm activity is allowed in the year of the loss. Generally, a tax shelter farm activity is any farming syndicate or any other passive farm activity. If you have more than one tax shelter farm loss, figure each loss separately. The loss from a tax shelter farm activity is allowed in figuring AMT taxable income for later years as a deduction against income from the activity or for the year you dispose of your entire interest in the activity.

The amount of the loss that is disallowed is reduced by the amount by which you are insolvent as of the end of the tax year. You are insolvent to the extent that your liabilities exceed the fair market value of your assets.

Note. In refiguring any tax shelter farm activity losses (for AMT), any resulting gain can be offset only by losses from other passive activities.

Passive activity loss. To determine your adjustment for a passive activity loss, you must refigure your loss using your AMT adjustments and preferences. (Do not enter these adjustments and preference items again on other lines of Form 6251.) Use a separate Form 8582, *Passive Activity Loss Limitations*, to refigure the loss. The passive activity phase-in rules do not apply for AMT purposes.

The adjustment is the difference between the allowable loss reported for regular tax and the refigured allowable loss. This figure could be negative if the recomputed allowable loss is more than the allowable loss reported for regular tax.

The amount of the loss that is disallowed is reduced by the amount by which you are insolvent as of the end of the tax year. You are insolvent to the extent that your liabilities exceed the fair market value of your assets.

Beneficiaries of estates and trusts. A beneficiary of an estate or trust must include in AMT taxable income his or her share of the estate or trust's distributable net AMT taxable income. This will be shown on the Schedule K–1 (Form 1041) you receive from the estate or trust. Your adjustment is the difference between the amount shown on the Schedule K–1 (Form 1041) and the amounts you report for regular tax purposes.

Tax Preference Items

Tax preference items are other income items and deductions that receive special treatment under the tax laws. They must be added back to the taxable income shown on your return in figuring your AMT taxable income.

Charitable contributions of appreciated property. If you make a charitable contribution of appreciated capital gain property, an amount equal to the portion of the regular tax deduction claimed that exceeds the adjusted basis of the property is treated as a tax preference item. For AMT purposes, capital gain property has the same meaning as under the rules relating to charitable deductions.

Do not make an adjustment for carryforwards of charitable contributions you made before August 16, 1986. Also, do not include property for which you made an election to figure the contribution deduction using the property's adjusted basis rather than its fair market value.

Tax-exempt interest on specified private activity bonds. This tax preference item is the interest on tax-exempt private activity bonds generally issued by a state or local government after August 7, 1986 (or on or after September 1, 1986, in the case of bonds satisfying pre-Tax Reform Act of 1986 definitions of governmental bonds). You reduce this interest by the expenses that were not allowed in figuring the regular tax because they are related to tax-exempt income, but that would have been allowable if the obligations were not exempt.

For purposes of this tax preference item, a private activity bond does not include a qualified section 501(c)(3) bond, or any current refunding bond if the refunded bond (or in the case of a series of refundings, the original bond) was issued before August 8, 1986. Any exempt-interest dividends you received from a mutual fund must be separated from total dividends and included in this preference item. In addition, any exempt-interest dividend will be treated as interest on a specified private activity bond to the extent of its proportionate share of the interest on such bonds received by the company paying the dividend.

Percentage depletion. If your depletion deduction for the year is more than your adjusted basis in the property at the end of the year (figured before reducing the basis by the depletion deduction), the difference is a tax preference item. This preference item should be figured separately for each piece of property being depleted.

Accelerated depreciation on real property placed in service before 1987. The depreciation or amortization you took during the year on real property placed in service before 1987 minus the depreciation you would have been allowed to take under the straight line method is a tax preference item. You must figure this amount separately for each item of property. Generally, each building (or its components) is a separate item of property. Do not figure this tax preference for an item of property in the year that you dispose of it.

For real property you depreciate under the accelerated cost recovery system (ACRS), figure straight line depreciation using a recovery period of 15 years for 15–year real property, 18 years for 18–year real property, and 19 years for 19–year real property, and no salvage value. However, if the actual recovery period used for regular tax purposes is longer than 15, 18, or 19 years, you will not have a tax preference item. ACRS is explained in Publication 534, *Depreciation*.

For property that you place in service after July 31, 1986, and choose to depreciate under the modified accelerated cost recovery system (MACRS), figure straight line depreciation generally using a recovery period of 40 years. MACRS is explained in Chapter 8.

For property you depreciate under another method, figure straight line depreciation using the same basis, useful life, and salvage value that you first used to depreciate the property. If you did not use a useful life or salvage value, the useful life or salvage value for straight line depreciation is the one that would have been proper if you had actually taken depreciation under the straight line method.

Accelerated depreciation on leased personal property placed in service before 1987. The depreciation or amortization you took during the tax year on personal property you leased to others minus the depreciation or amortization that you would have been allowed to take if you had used the straight line method is a tax preference item.

You must figure this preference item separately for each item of personal property you lease out. However, do not figure it for the year in which you dispose of the property.

For leased personal property that you depreciate under the accelerated cost recovery system (ACRS), figure straight line depreciation using a half-year convention, no salvage value, and the following recovery periods.

For:	Use a recovery period of:
3–year property	5 years
5–year property	8 years
10–year property	15 years
15–year public utility property	22 years

However, if the actual recovery period used in figuring the regular tax is longer than that listed, you will not have a tax preference item.

For property that you place in service after July 31, 1986, and choose to depreciate under the modified accelerated cost recovery system (MACRS), figure depreciation for AMT using the 150% declining balance method. The preference item is the difference between this amount and the depreciation you took for regular tax. However, if you figured depreciation for regular tax using the straight line or 150% declining balance methods, you will not have a preference item.

For property that you depreciate under methods other than ACRS, figure straight line depreciation using the same basis, useful life, and salvage value that you first used to depreciate the property. If you did not use a useful life or salvage value, then the useful life for straight line depreciation is the one that would have been proper if you had actually used the straight line method.

Amortization of certified pollution control facilities placed in service before 1987. Your amortization deduction for a certified pollution control facility minus the depreciation deduction that you would normally be allowed is a tax preference item. However, it is not a tax preference for the year in which you dispose of the facility.

Note. The depreciation normally allowed for this facility may be more than straight line depreciation. It may have already resulted in an item of tax preference under the accelerated depreciation rules (earlier). If the amortization deduction is treated as a preference item under the preceding paragraph, you do not have to treat it as an item of tax preference under the accelerated depreciation rules (earlier).

Intangible drilling costs. In general, the amount of excess intangible drilling costs paid or incurred during the year on your oil, gas, and geothermal properties that is more than 65% of the net income of these properties is a tax preference item. You may not have a tax preference item for intangible drilling costs if you chose one of the optional write-off periods described later.

Excess intangible drilling costs. These costs are those deductible costs incurred or paid in connection with oil, gas, and geothermal wells that exceed the amount that:

1) Would have been allowed if you had amortized the costs using a 10-year straight line method, or
2) Are allowed using the cost depletion method you actually selected.

Net income. The net income from oil, gas, and geothermal properties for AMT purposes is the gross income from all of these properties reduced by the deductions allocated to these properties. Deductions do not include excess intangible drilling costs or costs related to nonproductive wells.

Optional Write-Off

You can prevent certain deductible items from being treated as adjustments or tax preference items. You do this by writing off these items over 3 years, 60 months, or 10 years (depending on the item) when figuring your regular income tax.

3-year write-off. You can choose to deduct, in equal installments over a 3-year period, the cost of increasing the circulation of a newspaper or periodical.

60-month write-off. You can choose to deduct, in equal installments over a 60-month period beginning with the month the costs were paid or incurred, intangible drilling and development costs. These costs must have been paid or incurred in a tax year beginning after 1989.

10-year write-off. The costs you can choose to deduct in equal installments over a 10-year period are:

- Research and experimentation costs,
- Mining exploration and development costs, and
- Intangible drilling and development costs incurred in taxable years beginning before 1990.

Choosing the optional write-off. You must choose the optional write-off by the due date (including extensions) of your income tax return for the year for which you are making the choice. Attach a statement to your return which includes:

1) Your name, address, and social security number,
2) The specific write-off you are choosing,
3) A notation that you are making this choice under section 59(e) of the Internal Revenue Code,
4) The year for which you are making the choice, and
5) The tax preference item to which it applies.

You can use Form 4562, *Depreciation and Amortization,* to choose the optional write-off. Once you select the optional write-off for any qualified expenditure, your choice can be revoked only with the consent of the Internal Revenue Service.

Partnerships and S corporations. If the costs described above are incurred by a partnership or an S corporation, the optional write-off can be chosen only at the shareholder or partner level. These costs are passed through and should be shown on line 14 of Schedule K-1 of Form 1120S if you are an S corporation shareholder. For partners these costs should be shown on line 16 of Schedule K-1 of Form 1065.

Alternative Tax Net Operating Loss (NOL) Deduction

For tax years beginning after 1986, you must figure your alternative tax net operating loss (NOL) deduction differently than for 1986 and prior years.

Figuring alternative tax NOL after 1986. For AMT purposes, you figure an NOL for a tax year beginning after 1986 in generally the same manner as figured for regular tax, with the following exceptions:

- Make the AMT adjustments (discussed earlier) to the NOL that you figured for regular tax purposes, and
- Reduce the NOL by the tax preference items. The reduction cannot be more than the amount that these items increased the NOL.

Carrybacks and carryovers. After making the above calculations, the amount of the alternative tax NOL that you can deduct in a carryback or a carryover year cannot exceed 90% of your AMT taxable income for that year, as figured before your NOL deduction.

You can carry back your alternative tax NOL 3 years or carry it forward 15 years. This is the same as under the regular NOL rules. However, if you elect not to carryback the regular NOL, you cannot carry back the alternative tax NOL.

If you do not have an AMT liability in a carryback or carryover year, you still must reduce your net operating loss deduction by 90% of your AMT taxable income for that year. For this purpose, AMT taxable income is the amount you arrive at on line 6, Form 6251. You should use Form 6251 to figure the line 6 amount even though you do not have an AMT liability.

Pre-1987 carryovers. The amount of a net operating loss carryover from tax years beginning before 1987 that you can deduct in a tax year beginning after 1986 cannot exceed 90% of the AMT income for that year.

Note. All or part of an NOL carryover from a pre-1983 tax year may be subject to a 15% minimum tax. See *Deferred minimum tax,* in Publication 909.

Figuring AMT

After you have arrived at AMT taxable income, you can figure the tax (the AMT). Subtract from your AMT taxable income an exemption amount. The exemption amount varies depending on your filing status and your taxable income. Next multiply the balance by the AMT rate of 21%. This will be your tentative minimum tax. Subtract your regular tax (adjusted as explained later) from your tentative minimum tax. This is your AMT.

Exemption Amount

The AMT is not intended to apply to individuals in the lower tax brackets with small amounts of adjustments or preference items. This is why you subtract an exemption amount from your AMT taxable income before figuring your tentative minimum tax. The exemption amount is phased out for high income individuals.

You can subtract the following exemption amount based on the filing status you used to figure your regular tax:

- $40,000, if you are married filing a joint return or file as a qualifying widow or widower,
- $30,000, if you file as single or qualify as head of household, or
- $20,000, if you are married filing a separate return.

Note. The exemption amount for a child under 14 may be limited. See *Minor children,* later.

Phaseout. The exemption amount is reduced by 25 cents for each $1 that your AMT taxable income exceeds:

- $150,000, if you are married filing a joint return or file as a qualifying widow or widower,
- $112,500, if you are single or qualify as hea household, or
- $75,000, if you are married filing a separate return.

The exemption amount is completely phased AMT taxable income exceeds:

- $310,000, if you are married filing a joint re or file as a qualifying widow or widower,
- $232,500, if you are single or qualify as hea household, or
- $155,000, if you are married filing a separa return.

Married filing separately. If you are a ma person filing a separate return and your AMT ble income is more than $155,000, you must increase your AMT taxable income to figure phaseout of the exemption amount.

The increase in your AMT taxable income 25% of the amount by which your AMT taxal income exceeds $155,000. However, the inc cannot be more than $20,000.

Tentative Minimum Tax

To figure your tentative minimum tax, multipl AMT taxable income, minus the appropriate exemption amount, by 21%. This is your ten minimum tax unless you have an AMT foreig credit. If you have an AMT foreign tax credit, subtract it to arrive at your tentative minimur

For information on how to figure the credi how to carry it back or forward, see *Foreign credit* in Publication 909.

Regular Tax

After you have figured your tentative minimu subtract your regular income tax to arrive at AMT. Regular income tax is your income tax line 38, Form 1040, plus any tax from Form entered on line 39, Form 1040, minus any fo tax credit (line 43, Form 1040).

Credits. If you pay AMT, you will not obtai tax benefit from certain nonrefundable credi (listed below) other than the foreign tax cre you have adjustments or preference items b not pay AMT because of the exemption am you may or may not receive any benefit fron these credits.

You can only claim nonrefundable credits the amount that your regular tax liability exc your AMT liability. You cannot claim these c to the extent they reduce your regular tax li below the amount of your tentative minimur Any excess credit is not lost but will be allo a carryback or carryover under the usual ru that credit.

The nonrefundable credits include:

- Credit for child and dependent care expe
- Credit for the elderly or the disabled,
- Credit for fuel from a nonconventional so
- Targeted jobs credit,
- Alcohol fuels credit,
- Research credit, and
- Low-income housing credit.

Earned income credit. You must reduc earned income credit you claimed on your by the amount of your AMT.

Minor children. Limits apply to the exemp amount and the AMT of a child under 14 y age who has more than $1,000 of unearne income.

Limit on exemption amount. The chil exemption amount is limited to $1,000 plus child's earned income.

Limit on AMT. The child's AMT cannot be reater than the amount that the parent's minimum tax liability would be increased if the parent's ntative AMT and regular tax were increased by e amount of the child's AMT and regular tax.

For more information concerning the regular tax n the income received by minor children, and ow to allocate both the regular tax and the AMT you have more than one child subject to these ules, get Publication 929, *Tax Rules for Children nd Dependents*.

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xample of AMT

ohn Green is married and has two children. He nd his wife, Ann, file a joint return on which they laim four exemptions. Their only taxable income their net profit from a farm and interest income.

John and Ann report an adjusted gross income f $67,000. Their itemized deductions totaled 35,314 and are as follows:

nreimbursed medical expenses and medical insurance (after 7.5% limit)	$ 5,600
eductible state income taxes	4,900
eal estate tax	2,300
ome mortgage interest	7,000
ersonal interest (after 90% reduction)	375
haritable contributions of appreciated property	10,000
ther cash contributions	3,000
asualty loss (from Form 4684)	2,139
otal itemized deductions	$35,314

iguring regular income tax. John and Ann figure their taxable income as follows:

djusted gross income	$67,000
inus itemized deductions	35,314
	$31,686
xemptions (4 × $2,050)	8,200
axable income	$23,486

sing the Tax Table, the Greens find that their egular income tax is $3,521.

iguring alternative minimum tax. John and nn figure their AMT on Form 6251. They begin y entering their taxable income, line 37 of Form 040, on lines 1 and 3 of Form 6251. This amount $23,486. John and Ann then enter their djustments on lines 4a through 4u.

Personal exemptions. John and Ann must dd their personal exemptions ($8,200) to their xable income. They enter $8,200 on line 4b.

Medical expenses. The Greens took this eduction on Schedule A (Form 1040) after subtracting 7.5% of their adjusted gross income (AGI) om the total medical expenses. Since medical xpenses are allowed only in excess of 10% of GI for AMT purposes, the Greens must add 2.5% (10% minus 7.5%) of their AGI to their taxable income. They enter $1,675 (2.5% × $67,000) n line 4c.

Taxes. The Greens deducted $4,900 state ncome tax and $2,300 real estate tax on Schedule A (Form 1040). Since state income and real state taxes are not allowed for AMT purposes, e Greens enter $7,200 on line 4e.

Personal interest deduction. John and Ann aid $3,750 interest on credit cards, personal ans and a car loan. Their allowable deduction for egular tax purposes is 10% of that amount, $375. ince no amount of personal interest is allowed r AMT purposes, they enter $375 on line 4g.

Home mortgage interest deduction. The reens paid home mortgage interest of $7,000 uring 1990. Of this amount, $4,550 is the dditional interest from refinancing their mortgage (in 1990) for more than their original mortgage. They did not use the increased mortgage proceeds for home improvements. They enter $4,550 on line 4h.

Depreciation of property placed in service after 1986. John and Ann bought farm equipment in 1990 that for regular tax purposes they depreciate under the modified accelerated cost recovery system. For AMT purposes, they refigure the depreciation on this property using the 150% declining balance method. The difference, $5,220, is entered on line 4j.

Total adjustments. John and Ann enter their total adjustments, $27,220, on line 4u.

Tax preference items. Next John and Ann enter their tax preference items on lines 5a through 5h.

Charitable deduction of appreciated property. The Greens claimed a $10,000 deduction on Schedule A (Form 1040) for the value of land they donated to their church in 1990. They had an adjusted basis in the land of $2,000. Since their allowable charitable deduction for AMT purposes is limited to the adjusted basis, their tax preference is $8,000 ($10,000 minus $2,000). The $8,000 is entered on line 5a.

Tax-exempt interest. John and Ann received $4,000 tax-exempt interest from municipal bonds issued in December 1986. The bonds were industrial development bonds that qualified as private activity bonds. Expenses for this interest income were $300. Therefore, John and Ann enter $3,700 on line 5b.

Accelerated depreciation on real property placed in service before 1987. To the extent that accelerated depreciation claimed for regular tax purposes is more than straight line depreciation on a property-by-property basis, it is a tax preference item. Since John and Ann claimed accelerated depreciation on a building placed in service before 1987 that was $3,970 more than straight line depreciation, they enter $3,970 on line 5d.

Total tax preference items. John and Ann add these items and enter the total, $15,670, on line 5h.

AMT taxable income. The total of all John and Ann's adjustments, $27,220, and the total of all their tax preferences, $15,670, are then added to line 3 of Form 6251. The total, $66,376, is their AMT taxable income. This amount is entered on lines 6 and 8.

AMT. Since John and Ann are filing a joint return, they enter $40,000 on line 9, and $150,000 on line 10. Their AMT taxable income is less than $150,000. Therefore, there is no phaseout of the exemption amount and they enter –0– on lines 11 and 12, and $40,000 on line 13. They subtract the $40,000 from line 8. The difference, $26,376, is entered on line 14. On line 15, John and Ann multiply line 14 by 21%. The result, $5,539, is their tentative minimum tax (line 17). From this amount, they subtract their regular tax, $3,521. The difference, $2,018, is their AMT. This amount is entered on line 19. It is then carried to line 49 of Form 1040.

Minimum Tax Credit

You may be eligible to take a minimum tax credit against your regular income tax. If you paid AMT in an earlier year (after 1986), the part of it based on adjustments or preference items that deferred your tax liability rather than caused a permanent avoidance of the tax, can be claimed as a credit against your regular income tax. Use Form 8801, *Credit For Prior Year Minimum Tax*, to determine the amount of your credit.

Regular income tax reduced. The credit is limited to your regular income tax for the year to which it is carried minus the following:

- Credit for child and dependent care,
- Credit for the elderly or the disabled,
- Mortgage interest credit,
- Foreign tax credit,
- General business credit, and
- The tentative minimum tax for the year in which the credit is being used.

The credit you can take in 1990 is based on your 1989 net AMT and any unused credit carryforward from earlier years. Your net AMT is what you actually paid. However, your 1989 net AMT may have to be reduced, as explained next.

Figuring the credit. Your net AMT in each earlier year may have to be reduced to arrive at the amount you may use as a credit in 1990. If you had any of the following adjustments or preference items, which are treated as ***exclusions,*** you must reduce your net AMT by the AMT that would have resulted from only these items. In figuring the AMT on these items, you do not use the 90% limit on the AMT foreign tax credit.

Exclusions. These are adjustments and preference items that result in the permanent exclusion of income for regular tax purposes. The following AMT adjustments and tax preference items are exclusions:

- The standard deduction,
- Personal exemptions,
- Medical and dental expenses,
- Miscellaneous itemized deductions,
- Taxes,
- Interest expense,
- Depletion,
- Tax-exempt interest on specified private activity bonds, and
- Charitable contributions of appreciated property.

This reduced net AMT is the minimum tax credit available.

Carryforward of credit. You can carry the AMT credit forward (indefinitely) to reduce your regular tax liability in later years. If you do not use all the credit in 1990, the balance may be carried forward to 1991 and later tax years. If your net AMT in a later tax year results in additional credit, you can add that credit to any carryforward balance from earlier years (see Part II of Form 8801).

Other credits. If in a prior year, any part of the orphan drug credit or nonconventional fuels credit was disallowed because it was more than your tentative minimum tax for the year, you can increase your minimum tax credit for this year by the amount disallowed.

Example. Kenny and Tracy Hart paid a 1989 AMT of $6,526. They claim the minimum tax credit for 1990 (based on their 1989 AMT). To claim the credit they must complete Form 8801, *Credit For Prior Year Minimum Tax*. (Their filled-in Form 8801 is shown in this chapter.) They used the following amounts to figure their 1989 AMT on Form 6251.

Taxable income	$ 37,450
Adjustments	22,326
Tax preferences	42,110
Total	$101,886
Minus: Exemption amount	40,000
	$ 61,886
Multiply by 21%	×21%
	$ 12,996
Minus: Regular tax before credits	6,470
1989 alternative minimum tax	$ 6,526

To complete Form 8801, Kenny and Tracy must determine which of their 1989 AMT adjustments and preferences are treated as exclusions (explained earlier). They had the following

Form **6251**

Department of the Treasury
Internal Revenue Service

Alternative Minimum Tax—Individuals

▶ See separate instructions.

▶ Attach to Form 1040 or Form 1040NR. Estates and trusts, use Form 8656.

OMB No. 1545-0227

1990

Attachment Sequence No. 32

Name(s) shown on Form 1040: John and Ann Green

Your social security number: 000 : 00 : 0000

1	Taxable income from Form 1040, line 37. (If Form 1040, line 37 is zero, see Instructions.)			1	23,486
2	Net operating loss deduction, if any, from Form 1040, line 22. (Enter as a positive amount.)			2	
3	Combine lines 1 and 2			3	23,486
4	**Adjustments:** (See Instructions before completing.)				
a	Standard deduction, if any, from Form 1040, line 34	4a			
b	Personal exemption amount from Form 1040, line 36	4b	8,200		
c	Medical and dental expenses	4c	1,675		
d	Miscellaneous itemized deductions from Schedule A (Form 1040), line 24	4d			
e	Taxes from Schedule A (Form 1040), line 8	4e	7,200		
f	Refund of taxes	4f	( )		
g	Personal interest from Schedule A (Form 1040), line 12b	4g	375		
h	Other interest adjustments	4h	4,550		
i	Reserved	4i			
j	Depreciation of property placed in service after 1986	4j	5,220		
k	Circulation and research and experimental expenditures paid or incurred after 1986	4k			
l	Mining exploration and development costs paid or incurred after 1986	4l			
m	Long-term contracts entered into after 2/28/86	4m			
n	Pollution control facilities placed in service after 1986	4n			
o	Installment sales of certain property	4o			
p	Adjusted gain or loss	4p			
q	Certain loss limitations	4q			
r	Tax shelter farm loss	4r			
s	Passive activity loss	4s			
t	Beneficiaries of estates and trusts	4t			
u	Combine lines 4a through 4t			4u	27,220
5	**Tax preference items:** (See Instructions before completing.)				
a	Appreciated property charitable deduction	5a	8,000		
b	Tax-exempt interest from private activity bonds issued after 8/7/86	5b	3,700		
c	Depletion	5c			
d	Accelerated depreciation of real property placed in service before 1987	5d	3,970		
e	Accelerated depreciation of leased personal property placed in service before 1987	5e			
f	Amortization of certified pollution control facilities placed in service before 1987	5f			
g	Intangible drilling costs	5g			
h	Add lines 5a through 5g			5h	15,670
6	Combine lines 3, 4u, and 5h			6	66,376
7	Alternative tax net operating loss deduction. (Do not enter more than 90% of line 6.) See Instructions			7	
8	Alternative minimum taxable income. Subtract line 7 from line 6. If married filing a separate return, see Instructions			8	66,376
9	Enter: $40,000 ($20,000 if married filing separately; $30,000 if single or head of household)			9	40,000
10	Enter: $150,000 ($75,000 if married filing separately; $112,500 if single or head of household)			10	150,000
11	Subtract line 10 from line 8. If zero or less, enter -0- here and on line 12 and go to line 13			11	-0-
12	Multiply line 11 by 25% (.25)			12	-0-
13	Subtract line 12 from line 9. If zero or less, enter -0-. If completing this form for a child under age 14, see Instructions for amount to enter			13	40,000
14	Subtract line 13 from line 8. If zero or less, enter -0- here and on line 19			14	26,376
15	Multiply line 14 by 21% (.21)			15	5,539
16	Alternative minimum tax foreign tax credit. See Instructions			16	
17	Tentative minimum tax. Subtract line 16 from line 15			17	5,539
18	Enter your tax from Form 1040, line 38, minus any foreign tax credit on Form 1040, line 43. If an amount is entered on line 39 of Form 1040, see Instructions			18	3,521
19	**Alternative minimum tax.** Subtract line 18 from line 17. If zero or less, enter -0-. Enter on Form 1040, line 49. If completing this form for a child under age 14, see Instructions for amount to enter			19	2,018

Proof as of 10/16/90

For Paperwork Reduction Act Notice, see separate Instructions.

Form **6251** (1990)

Form **8801**

Department of the Treasury
Internal Revenue Service

Credit For Prior Year Minimum Tax

▶ **Attach to your tax return.**

OMB No. 1545-1073

1990

Attachment
Sequence No. **74**

Name(s) shown on return: Kenny and Tracy Hart

Identifying number: 000-00-1111

Part I Net Minimum Tax on Exclusion Items

1	Enter: line 3 of 1989 Form 6251, or line 1 of 1989 Form 4626. Form 1041 filers, see Instructions	1	37,450
2	Enter adjustments and tax preference items treated as exclusion items. See Instructions	2	60,111
3	**Minimum tax credit net operating loss deduction.** See Instructions	3	( )
4	Combine lines 1, 2, and 3. If zero or less, or if married filing separately, see instructions	4	97,561
5	Enter: line 9 of 1989 Form 6251, or line 9a of 1989 Form 4626. Form 8656 filers, enter $20,000	5	40,000
6	Enter: line 10 of 1989 Form 6251, or line 9b of 1989 Form 4626. Form 8656 filers, enter $75,000	6	150,000
7	Subtract line 6 from line 4. If zero or less, enter -0- here and on line 8 and go to line 9	7	-0-
8	Multiply line 7 by 25% (.25) and enter the result	8	-0-
9	Subtract line 8 from line 5. If zero or less, enter -0-	9	40,000
10	Subtract line 9 from line 4. If zero or less, enter -0- here and on line 15, and see Instructions	10	57,561
11	Form 6251 and 8656 filers, multiply line 10 by 21% (.21). Form 4626 filers, multiply line 10 by 20% (.20)	11	12,088
12	**Minimum tax foreign tax credit on exclusion items.** See Instructions	12	
13	**Tentative minimum tax on exclusion items.** Subtract line 12 from line 11	13	12,088
14	Enter: line 18 of 1989 Form 6251, line 15 of 1989 Form 4626, or line 11c, Part III, of 1989 Form 8656	14	6,470
15	**Net minimum tax on exclusion items.** Subtract line 14 from line 13. If zero or less, enter -0-	15	5,618

Part II Minimum Tax Credit and Carryforward to 1991

16	Enter: line 19 of 1989 Form 6251; the sum of lines 14 and 16 of 1989 Form 4626; or line 12, Part III, of 1989 Form 8656	16	6,526
17	Enter amount from line 15 above	17	5,618
18	Subtract line 17 from line 16. If line 17 is greater than line 16, enter the result as a negative amount	18	908
19	**Carryforward of minimum tax credit from 1989.** Enter amount on line 28 of 1989 Form 8801	19	800
20	Enter your 1989 unallowed credit for fuel produced from a nonconventional source. See Instructions	20	
21	Combine lines 18, 19, and 20. If zero or less, **do not** complete the rest of this form (see instructions)	21	1,708
22	Enter your 1990 regular income tax liability minus allowable tax credits. See Instructions	22	6,495
23	Enter: line 17 of 1990 Form 6251; line 13 of 1990 Form 4626; or line 10, Part III of 1990 Form 8656	23	5,552
24	Subtract line 23 from line 22. If zero or less, enter -0-	24	943
25	**Minimum tax credit.** Enter the **smaller** of line 21 or line 24. Also enter this amount on the appropriate line of your 1990 tax return. See Instructions	25	943
26	**Minimum tax credit carryforward to 1991.** Subtract line 25 from line 21. See Instructions	26	765

Proof as of 10/16/90

General Instructions

(Section references are to the Internal Revenue code.)

Paperwork Reduction Act Notice.—We ask for the information on this form to carry out the Internal Revenue laws of the United States. You are required to give us the information. We need it to ensure that taxpayers are complying with these laws and to allow us to figure and collect the right amount of tax.

The time needed to complete and file this form will vary depending on individual circumstances. The estimated average time is:

Recordkeeping	1 hr., 33 min.
Learning about the law or the form	1 hr., 6 min.
Preparing the form	1 hr., 3 min.
Copying, assembling, and sending the form to IRS	17 min.

If you have comments concerning the accuracy of these time estimates or suggestions for making this form more simple, we would be happy to hear from you. You can write to both the IRS and the Office of Management and Budget at the addresses listed in the instructions of the tax return with which this form is filed.

Purpose of Form

Form 8801 is used to compute the minimum tax credit, if any, for alternative minimum tax (AMT) incurred in prior tax years after 1986. The form is also used to figure any minimum tax credit carryforward that may be used in future years.

Who Should File

Form 8801 should be completed by individuals, corporations, trusts, and estates that had:

- an AMT liability in 1989 (or an amount on line 14 of Form 4626) and adjustments or tax preference items (other than exclusion items) in 1989;
- a minimum tax credit carryforward from 1989 to 1990; or
- a 1989 unallowed nonconventional source fuel credit (see Instructions for line 20 of this form).

Recordkeeping.—Use Form 8801 each year to see if you have a minimum tax credit and to keep track of any credit carryforward you can use in future years. (See line 26 of your 1988 Form 8801.)

Specific Instructions

The alternative minimum tax is attributable to two types of adjustments and tax preference items—those called "exclusion items" and those called "deferral items." The minimum tax credit is allowed only on the AMT attributable to deferral items.

Deferral items are generally adjustments and tax preference items that do not cause a permanent difference in taxable income over a number of years. An example is depreciation. **Exclusion items**, on the other hand, cause a permanent difference in taxable income. An example of an item that will cause a permanent difference is a personal exemption.

Line 1—Form 1041 filers.—Skip lines 1 through 3. Complete Parts I and II of another 1989 Form 8656. For Part I of Form 8656, take into account only exclusion items (the amount included on lines 4e and 6d of Part I of Form 8656). On line 9, Part I of Form 8656 use the minimum tax credit net operating loss deduction. However, do not limit the MTCNOLD to 90 percent of the amount on line 8, Part I of Form 8656 (see the instructions for line 3 below for how to compute the MTCNOLD). On Part II of Form 8656, do not take into account any basis "exclusion" adjustments and preferences on their 1989 Form 6251.

Exclusion adjustments:	
Personal exemptions	$ 8,000
Medical and dental	1,904
Miscellaneous itemized deductions from Schedule A, line 24	2,711
Taxes from Schedule A, line 8	5,002
Interest from Schedule A, line 12b	627
Mortgage interest adjustments	4,082
Exclusion preferences:	
Depletion	37,785
Total exclusion items for 1989	$60,111

The Harts also had intangible drilling costs of $4,325. This is ***not*** an exclusion preference.

For 1990, the Harts have a regular tax liability of $6,495 and a tentative minimum tax (line 17, Form 6251) of $5,552. They also have a minimum tax credit carryforward from 1989 (based on their 1988 AMT) of $800.

The Harts use their 1989 Form 6251 to complete Form 8801. They enter their total exclusion items ($60,111) on line 2 of Part I. Their net minimum tax on exclusion items is $5,618, as shown on line 15 of Part I. Then they complete Part II figuring an allowable minimum tax credit of $943 (line 25), and a carryforward minimum tax credit of $765 (line 26). The Harts can take a minimum tax credit of $943 against their regular 1990 income tax (reduced as explained earlier under *Regular income tax reduced*), and can carry forward to 1991 a minimum tax credit of $765. They enter their minimum tax credit on line 45 of Form 1040.

15. Self-Employment Tax

Important Changes for 1990

Maximum earnings for self-employment tax. The maximum net earnings subject to the self-employment tax for 1990 are $51,300.

Tax rate for self-employment tax. The self-employment tax rate for 1990 is 15.3%, and the 2% credit for 1989 has been replaced by two deductions. See *Tax rates*.

Farmers pay self-employment taxes on their self-employment income. Farmers who have employees may have to pay employment taxes. See Chapter 16 for information on employment taxes.

Self-employment tax is part of a system that provides farmers and other self-employed individuals with social security and medical insurance (Medicare) coverage. Self-employed individuals are those who operate their own businesses. Farmers who operate their own farms on land they either own or rent are usually self-employed, even if they employ someone to do the farm work and do not live on the farm.

Social security benefits are available to self-employed persons just as they are to wage earners. Your payments of self-employment tax contribute to your coverage under the social security system. You may be liable for self-employment tax even if you are now fully insured under social security or are now receiving benefits.

Income limits. You must pay self-employment tax if you have net earnings from self-employment of $400 or more. You must also pay self-employment tax if you are paid $100 or more in a year as an employee of a church or qualified church-controlled organization that elected exemption from social security taxes. However, see *Religious Exemptions* in Publication 533, *Self-Employment Tax*.

The minimum amounts, above, apply after your earnings or income are reduced by the new 7.65% deduction for figuring self-employment tax, discussed later.

For 1990, the maximum amount subject to self-employment tax is $51,300. However, no self-employment tax is due on your self-employment income if the wages you received in 1990 as an employee were $51,300 or more, and were subject to social security tax or railroad retirement tax, or both. The maximum amount subject to the self-employment tax may change for 1991.

Note. If you were a U.S. Government employee subject only to the 1.45% Medicare (hospital insurance benefits) tax, and your combined wages and self-employment earnings were in excess of $51,300, compute your self-employment tax by using the worksheet in the Form 1040 Instructions for Schedule SE.

The Medicare tax applies to most state and local government employees hired after March 31, 1986, and to state and local employees hired on or before that date who are covered by voluntary agreements with the Secretary of Health and Human Services.

Tax rates. After 1989, the self-employment tax rate is 15.3%, and the 2% credit for 1989 has been replaced by the following two deductions:

- A deduction of half your self-employment tax for the year is taken as a business expense in figuring adjusted gross income. This is an income tax deduction only, and you deduct it on line 25 of your 1990 Form 1040. It is not a deduction in figuring net earnings from self-employment subject to self-employment tax.
- A deduction of 7.65% of your net earnings from self-employment is taken when figuring self-employment tax. This deduction is allowed only in figuring self-employment tax, and you figure it on line 4 of your 1990 Schedule SE. It is not an income tax deduction.

Social security coverage. In 1990, you will receive a quarter of social security coverage, up to four quarters, for each $520 of self-employment income subject to the self-employment tax.

Forms. Form 1040, *U.S. Individual Income Tax Return*, is used to report self-employment tax. Income tax and self-employment tax are due at the same time. A separate schedule of Form 1040, Schedule SE, *Social Security Self-Employment Tax*, is used to figure the tax. Even if you are not otherwise required to file an income tax return, you must file both Form 1040 and Schedule SE to pay self-employment tax.

Joint returns. You cannot file a joint Schedule SE (Form 1040) even if you file a joint income tax return. Your spouse is not considered self-employed just because you are. If your spouse has self-employment income, it is independently subject to self-employment tax and should be reported on a separate Schedule SE. Mere ownership, or joint ownership, of farm property does not qualify a spouse for self-employment tax.

You and your spouse may operate a farm as a partnership. To be recognized as a partnership for federal tax purposes, your relationship as partners must be established. If you and your spouse operate a farm as partners, you must report the income on a partnership return, Form 1065, and attach separate Schedules K–1 to show each partner's share of the net income. If you file a j return, include both partners' share of the part ship's income on your Form 1040 and attach a separate Schedule SE (Form 1040) to report ea partner's self-employment tax.

However, if your spouse is not your partner, b rather is employed by you, you must pay social security taxes for your spouse. For more inform tion, see Chapter 16.

Community income. If any of the income from a farm or business other than a partnersh is community income under state law, it is subj to self-employment tax as the income of the spouse carrying on the trade or business. The identity of the person carrying on the trade or bu ness is determined by the facts in each case.

Social security number. You must have a social security number to pay self-employment tax. Your social security number must be shown on Schedule SE to insure proper credit of your self-employment income to your social security account. If you do not already have a number, y should apply for one on Form SS–5, *Application for a Social Security Card*.

If you have a social security number from the time you were an employee, you should not ap again. If you have a number but lost your card, y should file Form SS–5, showing where and abo when you first applied for it. You will get your or nal number and not a new one.

Estimated income tax. You must include the estimated self-employment tax in your estimate tax payments.

However, if at least two-thirds of your income from farming and you file your return and pay th tax by the first day of the third month after the e of your tax year, no estimated tax payments ar required.

Self-Employment Income

Net earnings from self-employment normally include all of the items of business income and take into account deductions allowed for incom tax purposes. Net earnings from self-employme are determined using the same accounting method as used for income tax purposes. How ever, if you use either of the optional methods your gross income is $2,400 or less, you do no need to list your deductions for self-employme tax purposes.

Some specific items included in determining earnings from self-employment are:

1) Taxable patronage dividends from cooperatives,
2) Government agricultural program paymen including commodity program payments, conservation reserve program (CRP) payments,
3) Taxable commodity credit loans,
4) Storage fees paid by the Commodity Cre Corporation under a reseal agreement to farmers for storing their own grain,
5) The part of the Dairy Termination Progra payment that is not treated as an amount ized on the sale of the dairy cattle if the m producer operated the milk production un personally or through agents or employee the milk production unit was operated by others and the milk producer participated materially in the production of the milk or the management of the milk production u
6) Refunds and rebates, if they represent a reduction in a deductible expense item, including the fuel tax credits,
7) Prizes or awards on farm produce or live
8) Crop damage payments,

) Value of merchandise received for farm products,

) Standing crop sales, if not sold with land which was held more than 1 year,

) Crop shares received as rent. (These are net earnings from self-employment in the year they are converted to money or the equivalent of money, if you meet the material participation test explained later under *Landlord Participation in Farming* at the time the crop shares are produced), and

2) Amounts recaptured under sections 179(d)(10) and 280F(b)(3) of the Internal Revenue Code because the business use of the property was reduced to 50% or less. (This does not include amounts recaptured on the disposition of property.)

addition, there are certain kinds of income and eductions you usually do not take into account in guring your net earnings from self-employment, ven though they are included in figuring your come tax:

1) Rent from real estate and from personal property leased with real estate is not self-employment income. It does not matter if the rent is received in crop shares, cash, or other property. However, if you are a real estate dealer and the rent is received in the course of your trade or business, the rental income and related deductions are included in figuring self-employment income. If the landlord materially participates, see *Landlord Participation in Farming,* later.
2) Interest is not self-employment income unless you receive it in your trade or business, such as interest on accounts receivable.
3) Dividends on securities are not self-employment income unless you are a dealer in securities.
4) Capital gains and losses, such as gain or loss on the sale of investment property, are excluded from self-employment income.
5) A gain or loss from the disposition of property that is neither stock in trade nor held primarily for sale to customers is not included when figuring self-employment income. It does not matter whether the disposition is a sale, exchange, or an involuntary conversion. For example, gains or losses from the disposition of the following types of property are not included:
    a) Depreciable property or other fixed assets used in your trade or business.
    b) Livestock held for draft, dairy, breeding, or sporting purposes, and not held primarily for sale, regardless of how long the livestock was held, or whether they were raised or purchased. This includes cattle sold under the Dairy Termination Program.
    c) Standing crops sold with land held more than one year.
    d) Timber, coal, or iron ore held for more than one year, if an economic interest was retained, such as a right to receive coal royalties.
    e) The cutting of timber, if it is treated as a sale or exchange.
6) Wages received for services performed as an employee and covered by social security tax or by railroad retirement tax are not self-employment income.
7) Certain deductions and exemptions that are used when figuring income tax should not be used to reduce your self-employment income. Specifically, do not use:
    a) Deductions for personal exemptions for yourself, your spouse, or your dependents,
    b) The standard deduction,
    c) The net operating loss deduction,
    d) The foreign expropriation loss deduction,
    e) Nonbusiness deductions, and
    f) The self-employed health insurance deduction.
8) A limited partner figures net earnings from self-employment by excluding the distributive share of partnership income or loss. But guaranteed payments received for services performed are included as self-employment income.
9) A retired partner does not include retirement payments received from the partnership under a written plan that provides for lifelong periodic payments as long as the retired partner's capital interest has been fully paid and the partner performs no services for the partnership.

Who Must Pay the Tax

If you carry on a trade or business, such as running a farm, you probably have to pay self-employment tax on your self-employment income. A trade or business is generally an activity carried on for a livelihood, or in good faith to make a profit.

Share farmers. If, under a crop-sharing arrangement, you produce a crop or raise livestock on land belonging to another and your share of the crop or livestock, or the proceeds from their sale, depends on the amount produced, you are a self-employed farmer. Your income from the crop-sharing arrangement is your self-employment income.

If you produce a crop or livestock on land belonging to another and are to receive a specified rate of pay, a fixed sum of money, or a fixed quantity of the crop or livestock, and not a share of the crop or livestock or their proceeds, you may be self-employed or an employee of the landowner. This will depend on whether you are under the direction and control of the landlord.

Example. A share farmer produces a crop on land owned by another person, on a 50–50 crop-share basis. By the terms of their agreement, the share farmer furnishes the labor and half the cost of seed and fertilizer. The landowner furnishes the machinery and equipment used to produce and harvest the crop, and half the cost of seed and fertilizer. A house to live in is provided for the share farmer. The landowner and the share farmer decide how much of the tract should be planted in cotton and how much in other crops. In addition, the landowner is in the hog business and the share farmer agrees to take care of the landowner's hogs in return for three hogs. The landowner furnishes the feed and other necessities and supervises the care of the hogs.

The share farmer is a self-employed farmer for purposes of the agreement to produce the cotton and other crops, and the share farmer's part of the income from the crops is self-employment income. But, for the services performed in caring for the landowner's hogs, the share farmer is an employee, and the value of the three hogs received is not self-employment income. This income is taxable for income tax purposes.

Self-employed child. Your child may be required to file Schedule F (or C) and Schedule SE (Form 1040) and pay the tax if the child carries on an activity such as a 4-H or FFA project. Income from the project is self-employment income.

Figuring Self-Employment Tax

If you were self-employed during the year, you must figure how much of your income is subject to self-employment tax. There are three steps to figure how much tax you owe:

1) Determine your net earnings from self-employment.
2) Determine how much of those net earnings are subject to the tax.
3) Multiply that amount by the tax rate.

When figuring your net earnings, you should include only income and expenses that come about in the regular course of your trade or business (including the farming business). There are three ways to figure self-employment net earnings. These are the regular method, the farm optional method, and the nonfarm optional method.

The two optional methods are intended to permit continued coverage for self-employment tax purposes when your net profit for the year is small or you have a loss. The optional methods are used only to figure self-employment tax. Do not use them to figure your income tax.

The three methods differ in the way you determine net earnings. However, the kinds of excluded income and deductions, the minimum and maximum income limits, and the tax rate are the same for each method. The general rules for figuring self-employment tax are found in the regular method below.

Short Schedule SE. Most taxpayers can use *Short Schedule SE* (Section A) to figure self-employment tax.

However, the following taxpayers must use *Long Schedule SE* (Section B):

Ministers, members of religious orders, and Christian Science practitioners not taxed on their earnings (with IRS consent) who owe self-employment tax on other earnings,

Government employees subject only to the 1.45% Medicare part of social security taxes, if wages plus self-employment earnings are more than $51,300,

Employees of churches or church organizations that elected exemption from social security taxes,

Individuals with tip income subject to social security taxes that was not reported to their employers, and

Individuals who use one of the optional methods to figure self-employment tax.

For more information on Schedule SE, see Publication 533, *Self-Employment Tax.*

Regular Method

This method can be figured on either *Short Schedule SE* (Section A), or *Long Schedule SE* (Section B). The short schedule is the easier one to use. Use the following steps to figure the tax.

First step. Under the regular method, the first step is to figure what your earnings from self-employment are. The net income from your business or profession is generally your net earnings from self-employment. Net income is figured by subtracting all allowable business expenses and deductions from gross business income.

If you have a trade or business, in addition to the farming business, your net earnings from self-employment are the combined net earnings from each of your businesses. You must also include your distributive share of self-employment net earnings or loss from a partnership. A loss in one of your businesses will offset the income you earned in another.

You must claim all allowable deductions, including depreciation, when figuring your net earnings from self-employment. Making false statements to get or to increase social security benefits may subject you to penalties.

Second step. The second step, after you figure your net earnings from self-employment, is to determine how much of those earnings you have to pay tax on. Your net earnings are reduced by the new 7.65% deduction for figuring self-employment tax, and there is both a minimum and a maximum income limit.

New 7.65% deduction for figuring self-employment tax. Multiply your net earnings by 0.9235 for this new 7.65% deduction (100 − 7.65% = 92.35% or 0.9235).

Minimum income limit. You must have $400 or more of net earnings from self-employment after reduction by the new 7.65% deduction to be subject to the tax. If your net earnings are less than $400, you do not have to file Schedule SE (Form 1040) or pay the tax. If you are an employee of a church or qualified church-controlled organization that is exempt from social security taxes, you must pay the self-employment tax if you are paid $100 or more in a year. However, see *Religious Exemptions* in Publication 533.

Maximum income limit. No more than $51,300 of your earnings in 1990 is subject to any combination of self-employment tax, social security tax, or railroad retirement tax. If you have wages in 1990 that are subject to social security or railroad retirement tax, or both, subtract these wages from $51,300 to arrive at the maximum amount subject to the self-employment tax. If your wages are subject to social security or railroad retirement tax, or both, and total at least $51,300, you do not have to pay self-employment tax. The maximum amount may increase for 1991.

Third step. The third step, after you determine how much of your net earnings are subject to the self-employment tax, is to multiply that amount by the tax rate for 1990 of 15.3% (0.153). The result is the amount of self-employment tax you owe.

Example 1. During 1990, you have $30,000 in net earnings from self-employment, and receive no wages subject to social security tax. You multiply the $30,000 by 0.9235 for the new 7.65% deduction (100% − 7.65% = 92.35%), and the result is $27,705. Your self-employment tax is 15.3% (0.153) of $27,705, or $4,238.87.

Example 2. During 1990, you have $20,000 in net earnings from self-employment, and receive $15,000 in wages subject to social security tax. You multiply the $20,000 by 0.9235 for the new 7.65% deduction, and the result is $18,470. Since your wages subtracted from the $51,300 maximum for 1990 are more than $18,470 ($51,300 − $15,000 = $36,300), your tax is 15.3% (0.153) of $18,470, or $2,825.91.

Farm Optional Method

If you are in the farming business, either as an individual or as a partner (other than a limited partner) in a farm partnership, you may be able to use the farm optional method to figure your net earnings from farm self-employment. This method allows you to continue coverage for self-employment tax when your net profit for the year is small or you have a loss.

Gross income of $2,400 or less. If your gross income from farming is $2,400 or less, you may report two-thirds of this gross income as your net earnings from farm self-employment.

Gross income of more than $2,400. If your gross income from farming is more than $2,400, and your actual net earnings from farm self-employment, as shown on line 36 of Schedule F (Form 1040), and line 15a of Schedule K-1 (Form 1065), are less than $1,733 (0.9235 × $1,733 = $1,600.43), you may report $1,600 as your net earnings from farm self-employment. But if your gross income from farming is more than $2,400 and your actual net earnings from farm self-employment are $1,733 or more, you cannot use the optional method.

Gross income from farming. Farming income includes what you receive from cultivating the soil or raising or harvesting any agricultural commodities. It also includes income from the operation of a livestock, dairy, poultry, bee, fish, fruit, or truck farm or plantation, ranch, nursery, orchard, or oyster bed, as well as income you receive in the form of crop shares if you materially participate, as explained later.

Your gross income will not include any item listed as being excluded under the regular method. Government commodity program payments that you receive on land you rent out are not included unless you meet the material participation test. When you use the farm optional method, you must also exclude income, deductions, and losses that come from any nonfarm business.

Cash method. If you file your return on the cash method and are not a member of a farming partnership, your gross income from farming will ordinarily be the amount shown on line 11 of Schedule F.

Accrual method. If you file your return on the accrual method and are not a member of a farming partnership, your gross income from farming will ordinarily be the amount shown on line 51 of Schedule F.

Gross income from a farming partnership. Your gross income under the farm optional method includes your distributive share of a partnership's gross income from farming.

To determine your distributive share of gross income from a farming partnership:

1) Figure the partnership's gross income from farming.
2) Subtract any guaranteed payments to partners for services or the use of capital if the payments are determined without regard to partnership income.
3) Determine your share of what is left. The gross income that remains after steps (1) and (2) is divided among the partners in the same way they share the ordinary income or loss of the partnership, unless the partnership agreement provides otherwise.
4) Add any guaranteed payments you receive from the partnership that are determined without regard to partnership income.

Your total after these steps will be your share of partnership gross income.

Example. Bill and John are partners and share in ordinary income or loss on a 50–50 basis, with no guaranteed payments. If the partnership has $3,000 gross income from farming, each would have $1,500 gross income for purposes of the optional method.

If Bill had been guaranteed $1,000 without regard to partnership income, his gross income from farming would be $2,000 ($1,000 plus 50% of $2,000). John's gross income would be $1,000.

Two or more farms. If you run your own farm and are also a partner in a farm partnership, or in any way have gross income from farming from more than one farm, you must add your farm income from all farming sources to get your total net earnings from farm self-employment. If you use the farm optional method, you must add all gross income from farming to make the $2,400 test.

Example. Your gross income from your own farm is $600, and your distributive share of the gross income from a farm partnership is $900. Your gross income from farming is $1,500, and your net earnings from self-employment under the farm optional method are $1,000 (⅔ of $1,500).

Figuring the tax. If your net earnings under the farm optional method are $400 or more, multiply the net earnings figure by the tax rate for 1990 (15.3%). The result is the amount of self-employment tax you owe.

Optional earnings less than actual earnings. If your net earnings under the farm optional method are less than your actual earnings, you can still use the farm optional method. For example, your actual self-employment net earnings are $425, and your net earnings figured under the farm optional method are $360. You owe no self-employment tax if you use this method because your net earnings fall below $400. However, if you want to contribute to your social security coverage, you could use your actual net earnings to determine your self-employment tax.

Nonfarm Optional Method

There is an optional method available for determining net earnings from nonfarm self-employment much like the farm optional method.

If you are engaged in a nonfarm business in addition to your farm business, you may be able to use this method to compute your net earnings from self-employment from your nonfarm business. You may use this method even if you do not use the farm optional method for determining your net earnings from your farm self-employment and even if you have a net loss from your nonfarm business. For more information about the nonfarm optional method, see Publication 533.

Using Both Methods

You may not combine income from farming with nonfarm income from self-employment to figure your net earnings under either of the optional methods. If you use both optional methods, you must add together the net earnings figured under each method to arrive at your total self-employment net earnings. You may report less than actual total net earnings but not less than actual net earnings from nonfarm self-employment alone when using both methods. If you use both optional methods, you may report no more than $1,600 as your combined net earnings from self-employment.

Earned income credit. If you use either of the optional methods to figure your net self-employment income, you may be entitled to claim the earned income credit. To determine if you qualify, you should see the discussion of the *Earned Income Credit* and the Worksheet that is included in the Form 1040 Instructions.

Landlord Participation in Farming

As a general rule, income and deductions from rentals and from personal property leased with the real estate are not taken into account to determine net earnings from self-employment. However, income and deductions from farm rentals and from personal property leased with the real estate, including government commodity program payments received by a landowner who rents land, are different. They must be taken into account if the rental arrangement provides that the landlord rather than an agent of the landlord will participate materially in the production or management of production of the farm products on the land.

dition, rent paid in the form of crop shares
ded in determining net earnings from self-
ment for the year you sell, exchange, give
r use the crop shares. You must meet the
l participation tests at the time the crop
are produced. Feeding such crop shares to
ck is considered using them. The income
u include when figuring your net earnings
elf-employment under the *Farm Optional*
d is the fair market value of the crop shares
hey are used as feed. However, you may
ed this amount when figuring net earnings
elf-employment under the *Farm Optional*
d.

participation. Under the arrangement,
dlord must actually participate materially in
duction or management of production of
m products on the land.

ally participating. You are materially par-
ng if you have an arrangement with your
for your participation and you meet one of
r following tests:

t No. 1. You do any three of the following:
y or stand good for at least half the direct
of producing the crop; (2) furnish at least
e tools, equipment, and livestock used in
cing the crop; (3) consult with your tenant;
) inspect the production activities
ically.

t No. 2. You regularly and frequently make,
e an important part in making, management
ons substantially contributing to or affecting
ccess of the enterprise.

t No. 3. You work 100 hours or more
d over a period of 5 weeks or more in
ies connected with crop production.

t No. 4. You do things which, considered in
otal effect, show that you are materially and
cantly involved in the production of the farm
odities.

se tests may be used as general guides for
mining whether you are materially participat-
you need more information, contact your
l Security office.

information on the material participation
ement as it relates to the special-use valua-
f qualified real property, see Publication 448,
ral Estate and Gift Taxes.

eporting Your Tax

farm and also have another business, you
d figure your self-employment tax from both
arm and the other business on one Schedule
lse Short Schedule SE unless you are using
tional method.

u should first figure your net earnings from
farm self-employment and show the amount
e 1 of Schedule SE.

xt enter the amount of your net earnings from
employment from your other business on line
Schedule SE. Then add these amounts
her and enter the total on line 3. This gives
total net earnings from self-employment from
urces.

mplete Schedule SE as explained in the
uctions with your return to figure your total
employment tax. Enter this amount on line 48
rm 1040.

16. Employment Taxes

Important Changes for 1990

Maximum wages for social security taxes. The maximum wages subject to social security taxes for 1990 are $51,300.

Tax rate for social security taxes. The tax rate for social security taxes for 1990 is 7.65% for both the employee and the employer. For 1991, the tax rate remains at 7.65%.

Federal unemployment (FUTA) tax rate. The gross FUTA tax rate remains at 6.2% through 1990. For 1991, the tax rate decreases to 6.0%.

Farmers and crew leaders must withhold income tax. For wages paid after 1989, farmers and crew leaders must withhold income tax from farm workers who are subject to social security taxes.

Federal deposit penalties. After 1989, the penalty for a late tax deposit is based on the length of time the deposit is late. See *Penalties*.

New $100,000 deposit rule. After July 31, 1990, and before 1991, undeposited taxes that reach $100,000 or more in any eighth-monthly deposit period must be deposited on the next banking day. You are still required to make deposits within 3 banking days when undeposited taxes reach at least $3,000 at the end of an eighth-monthly deposit period. See *Deposit rules*.

Farmers who have employees may have to pay employer and employee social security (FICA) taxes, and withhold income tax. They may also have to pay the federal unemployment (FUTA) tax. This chapter includes information about those taxes. Farmers also must pay self-employment tax on their earnings from farming. See Chapter 15 for information on the self-employment tax.

Social Security Taxes

As a farmer-employer, you may have to pay social security taxes if you have one or more agricultural employees, including your parents, your children 18 years of age or older, or your spouse, who meet either of these two tests:

1) You paid the employee $150 or more in **cash** wages during the year, or
2) You paid wages of $2,500 or more during the year to all your employees and did not meet the exception, below.

Cash wages. Cash wages include checks, money orders, and any other kinds of money or cash. The value of payments made with other items, such as food, lodging, farm products, clothing, transportation passes, and other goods and commodities, are not included in cash wages.

Exception. If you pay a farm worker less than $150 in annual cash wages, the wages are not subject to social security taxes even if you pay $2,500 or more to all your farm workers if the farm worker:

- Works as a hand-harvest laborer,
- Is paid piece-rates in an operation usually paid on this basis in the area,
- Commutes daily from his home to the farm, and
- Worked in agriculture less than 13 weeks in the preceding calendar year.

Payments to these farm workers, however, count toward the $2,500-or-more test for other farm workers.

If one of these tests was met, you are required to withhold social security taxes from the cash wages paid to the employee. If you employ a family of workers, you will have to deduct social security taxes and prepare a Form W–2 for each family worker, not just for the head of the family. These withheld taxes, together with an amount representing your employer taxes, are to be paid to the Internal Revenue Service (IRS). If you are subject to these taxes, you must file a Form 943, *Employer's Annual Tax Return for Agricultural Employees*, with the IRS at the address shown in the instructions for that form on or before January 31 of the year following the year covered by the return. If you are liable for $500 or more of social security taxes and withheld income taxes during the year, you must deposit them currently. See *Deposit rules*, later.

For 1990, your social security tax rate is 7.65%, and your employee's tax rate is also 7.65%. (For 1991, both tax rates are scheduled to remain at 7.65%.) The wages subject to social security taxes are limited to the first $51,300 of wages you pay each employee during calendar year 1990.

Circular A. Circular A, *Agricultural Employer's Tax Guide*, contains tables showing the amount of social security taxes you should withhold. It also contains additional information about social security tax withholding. You can get Circular A from the IRS Forms Distribution Center.

Paying employee's share. If you would rather pay the employee's share of social security tax without deducting it from his or her wages, you may do so. If you do not deduct the tax, you must still pay it. Any employee social security tax you pay is additional income to the employee. You must include it on the employee's Form W–2 in box 10, *Wages, tips, other compensation*, but do not count it as cash wages for farm work for social security or federal unemployment tax purposes.

New employees. You must ask each new employee to complete the employee part of Immigration and Naturalization Service (INS) Form I–9, *Employment Eligibility Verification*. You must then complete the employer part of the form to verify the employee's identify and eligibility to work. You can get Form I–9 from INS offices. For more information, contact the INS.

Family members. Social security does not cover the services of a child under the age of 18 who works for his or her parent in a trade or business. If these services are for work other than a trade or business, such as domestic work in the parent's private home, they are not covered by social security until the child reaches 21.

Federal unemployment does not cover the services of a child under the age of 21 who works for his or her parent (whether or not in a trade or business).

The above rules apply even if the child is paid regular wages. The wages for these services are not subject to social security or federal unemployment taxes. But the wages may still be subject to income tax withholding.

One spouse employed by another. The services of an individual who works for his or her spouse in a trade or business are covered by social security taxes, but not by federal unemployment taxes. However, the services of one spouse employed by another in other than a trade or business, such as domestic service in a private home, are not subject to social security taxes or federal unemployment taxes.

Covered services of a child or spouse. The services of a child are covered by social security and federal unemployment, and the services of a married individual are covered by federal unemployment, if he or she works for:

1) A corporation, even if it is controlled by the child's parent or the individual's spouse;
2) A partnership, even if the child's parent is a partner, unless each partner is a parent of the child;
3) A partnership, even if the individual's spouse is a partner; or
4) An estate, even if it is the estate of a deceased parent.

Under these conditions, a child is not considered to work for his or her parent, and a married individual is not considered to work for his or her spouse.

Income Tax Withholding

After 1989, farmers and crew leaders must withhold income tax from farm workers who are subject to social security taxes. The amount to withhold is figured on gross wages without taking out social security taxes, union dues, insurance, etc. Several methods may be used to determine the amount of income tax withholding. They are described in the 1990 Circular A (Publication 51) *Agricultural Employer's Tax Guide.*

Generally, you must withhold income tax from wages you pay an employee if the wages, cash and noncash, are more than the amount of withholding allowances for that pay period. Do not withhold income tax from the wages of an employee who, by filing Form W–4, *Employee's Withholding Allowance Certificate*, certifies that he or she had no income tax liability last year and anticipates no income tax liability for the current year.

Circular A. Circular A, *Agricultural Employer's Tax Guide*, contains tables showing the correct amount of tax you should withhold. It also contains additional information about income tax withholding. You can get Circular A and Form W–4 from the IRS Forms Distribution Center.

Report the income tax withheld on Form 943 at the same time the social security taxes are reported. However, depending upon the amount of income and social security taxes withheld, you may have to deposit them currently.

Form W-4 for 1991. Farmers who have employees should make new 1991 Forms W–4 available to their employees, and encourage them to check their income tax withholding situation for 1991. Those employees who owed a large amount of tax or received a large refund for 1990 may want to file a new 1991 Form W–4.

Backup withholding. In certain cases, the law requires payers to withhold income tax at 20% (backup withholding) on payments of interest, dividends, and patronage dividends. The backup withholding requirement also applies to rents, royalties, commissions, nonemployee compensation, and other payments that payers make in the course of farming or other business activities. The payer must withhold 20% of the payment if:

1) The payee does not furnish a taxpayer identification number to the payer,
2) IRS notifies the payer that the payee furnished an incorrect taxpayer identification number,
3) The payer is notified that the payee is subject to backup withholding for underreporting interest or dividends,
4) For accounts opened after 1983 on which interest or dividends were paid, the payee does not certify to the payer, under penalties of perjury, that he or she is not subject to backup withholding for underreporting interest or dividends, or
5) For accounts opened after 1983 on which interest or dividends were paid or payments by a broker or barter exchange were made, the payee does not certify to the payer, under penalties of perjury, that the taxpayer identification number furnished is correct.

Amounts withheld under the backup withholding provisions are reported on Form 941 or Form 941E. Form 943 filers must also report backup withholding on Form 941 (or Form 941E). You can combine these amounts with your employment taxes for deposit purposes or, if you choose to treat them separately, you can show the backup withholding amounts on Schedule A (Form 941), *Record of Federal Backup Withholding Tax Liability*. At the end of the year, these amounts are reported on information returns in the 1099 series (see *Information Returns (Forms 1099)* in Chapter 2 of this publication). For more information on information returns and backup withholding, get a booklet titled: *1990 Instructions for Forms 1099, 1098, 5498, and W-2G.*

Form W-9, *Request for Taxpayer Identification Number and Certification*, may be used by payers to request payees to furnish a taxpayer identification number and to certify that the number furnished is correct.

Paying Social Security and Withheld Income Taxes

You must deduct and withhold both income and social security taxes from the salaries and wages of your employees if they are subject to social security taxes. You are liable for the payment of these taxes to the federal government whether or not you collect them from your employees. If, for example, you deduct less than the correct tax from your employees' wages, you are still liable for the full amount.

Report the taxes on Form 943, *Employer's Annual Tax Return for Agricultural Employees*. File by January 31, 1991, for calendar year 1990.

Figuring deposits. The frequency of your deposits of withheld income tax and social security taxes on wages paid for agricultural labor and the time you have to make them vary, depending upon the amount of taxes and how often your paydays occur.

Each return period is divided into a number of shorter deposit periods. Whether or not you must make a deposit for a particular deposit period depends on the amount of tax you owe at the end of the period. If the tax you owe has reached a certain amount, a deposit is required.

If by the end of a deposit period the amount you owe has not reached the amount requiring a deposit, it is carried over and added to the tax for the next deposit period. If the total tax at the end of that period still has not reached the amount requiring a deposit, it is carried over again to the next deposit period—and so on until either a deposit is required or the return period ends. Once a tax amount requiring a deposit is reached, that amount is not considered when figuring whether any future deposits are required.

Deposits are figured separately for each return period, which is a calendar year for Form 943. Do not add the tax owed for one return period to the tax owed for another return period when figuring deposits.

Deposit rules. For social security and withh income taxes, each month of the return period is divided into eight deposit periods. These periods end on the 3rd, 7th, 11th, 15th, 19th, 22nd, 25th, and last day of every month. Whether you are required to deposit the social security and withhold income taxes you owe at the end of a depos period depends on the following rules:

1) ***New $100,000 rule.*** After July 31, 1990, and before 1991, if your undeposited taxes reach $100,000 or more in any eighth-monthly deposit period, you must deposit at least 95% of such taxes on the next banking day. If, by t end of that same eighth-monthly period, your additional undeposited taxes reach at least $3,000 but less than $100,000, you must deposit at least 95% of these additional taxe within 3 days after the end of that period. See Schedule B (Form 941), *Supplemental Reco of Federal Tax Liability*, for more information, and use that schedule to report your tax liab ity if it is $100,000 or more.
2) ***$3,000 rule.*** If the tax you owe is $3,000 or more at the end of any of the eight deposit periods during the month (including tax from earlier deposit periods in the month), you must deposit at least 95% of what you owe within three banking days. (You must then make up the difference in another deposit no later than the first deposit after the 15th of th next month. See Form 943 for details.)
3) ***$500 rule.*** If the tax you owe is $500 or more at the end of the month, you must deposit al of it by the 15th of the next month. However, this rule does not apply if the $3,000 rule applies during the same month.

At the end of the return period, if the tax you owe is less than $500, you must deposit it by the end of the next month or pay it when you file your return.

How to make deposits. Make your deposit b mailing or delivering a single check or postal money order covering both social security and withheld income taxes to an authorized financial institution or a Federal Reserve bank. (The Federal Unemployment Tax, explained later, must be paid separately.) Write your employer identificati number, "Form 943," and the tax period the deposit applies to on your check or money order. You can get the names of authorized institutions from a Federal Reserve bank. Each deposit mus be accompanied by a federal tax deposit (FTD) coupon. It is very important to clearly mark the correct type of tax and tax period on each depo coupon. This information is used by the IRS to credit your account.

A Federal Tax Deposit Coupon Book contain a supply of Form 8109, *Federal Tax Deposit Coupon*, and instructions will automatically be sent to you after you apply for an employer iden fication number. If you do not receive a book of coupons, contact an IRS office. If you need mor coupons, order them using the reorder form in th coupon book. Be sure to show your name, employer identification number, and address on the reorder form. If needed, mark an "X" in the box for an address change and show the addre where you want the coupon book sent on the reorder form. This will not change your address the mailing of returns, refunds, or notices.

It takes about 5 or 6 weeks for delivery of the coupons. Allow ample time to reorder before us up your current supply. If you have a deposit du and there is not enough time to obtain a coupo book, blank forms (Form 8109–B, *Federal Tax Deposit Coupon)* are available at IRS offices.

Note: Do not use a Federal Tax Deposit Coupon to deposit delinquent taxes you have been assessed by the IRS. These payments should be mailed to the IRS Service Center tha assessed the taxes together with copies of any related notices.

meliness of deposits. The timeliness of a posit depends on the date the authorized finan- l institution or Federal Reserve bank receives it. deposit received after the due date will be con- ered timely if you can establish that it was iled at least 2 days before the due date. How- er, deposits of $20,000 or more by an employer quired to deposit tax more than once a month st be received by the due date to be timely.

If you fail to deposit social security and withheld come taxes on time, you may have to pay a nalty.

rms for employees. By January 31, you must mish each employee from whom you withheld come tax or social security taxes, or to whom u paid any amount for services, a statement owing total wages and total income tax and cial security taxes withheld. However, if an ployee requests the form earlier, you must give o him or her within 30 days of the request or thin 30 days after your final payment of wages that person, whichever is later. See *Form W–2, age and Tax Statement*, in Chapter 2 of this blication.

enalties. There are criminal and civil penalties r willful failure to file returns and pay taxes when e. Also, there are penalties for willfully filing se or fraudulent returns.

If you withhold income and social security taxes om employees and do not pay the taxes to IRS r deposit them, you may be subject to a penalty 100% of the tax. If you are the person responsi- e for the collection and payment of withholding es, you can be subject to this penalty even if u are an officer or employee of a corporation or member or employee of a partnership.

Federal tax deposit penalties. Beginning in 90, the penalty for a late tax deposit is based n the length of time the deposit is late. The llowing penalties now apply for late deposits:

1) If the deposit is not more than 5 days late, the penalty is 2% of the underpayment.
2) If the deposit is more than 5 days late but not more than 15 days late, the penalty is 5% of the underpayment.
3) If the deposit is more than 15 days late, the penalty is 10% of the underpayment.
4) If the deposit is not made within 10 days after IRS issues the first notice demanding payment or by the day that notice and demand for immediate payment is given, the penalty is 15% of the underpayment.

dditional Information. For further information bout withholding, depositing, and paying social ecurity taxes on farm labor, get Circular A. Also et Circular E for additional information on income x withholding.

Federal Unemployment Tax

f you, as a farmer-employer, pay cash wages, you ust pay federal unemployment (FUTA) tax if you eet either of the following two tests:

1) You paid cash wages of $20,000 or more to farm workers in any calendar quarter during the current or preceding year, or
2) You employed 10 or more farm workers for some part of at least 1 day during each of 20 different calendar weeks during the current or preceding year.

These rules do not apply to your spouse, parents, r children under age 21. See *Family members*, arlier, under *Social Security Taxes*.

The federal unemployment tax does not apply o wages paid to an alien who was admitted to the United States to perform farm labor before 1993 nder a contract to you and who returns to his or her own country when the contract is completed. However, wages paid to an alien worker are counted in figuring whether you are subject to the federal unemployment tax for your other farm workers under the two tests above.

Only employer pays tax. The federal unemployment tax is imposed on you as the employer. It must not be collected or deducted from the wages of your employees.

Tax rate. The gross tax rate is 6.2% on the first $7,000 of cash wages paid to each employee during 1990. (The rate is scheduled to decrease to 6.0% for 1991.) You may receive a credit of up to 5.4% for the state unemployment tax you pay. If your state tax rate (experience rate) is less than 5.4%, you are still allowed the full 5.4% credit. Thus, your net federal liability may be as low as 0.8% in 1990 (0.6% in 1991) if your state is not subject to a credit reduction. The federal liability, however, remains in effect even though you may be exempt from state unemployment tax or your employees are ineligible for unemployment compensation benefits. Form 940, *Employer's Annual Federal Unemployment (FUTA) Tax Return*, is designed to take state credits into account.

Deposit rules for FUTA taxes. If the amount subject to deposit (plus the amount subject to deposit for any prior quarter but not deposited) is more than $100, you must deposit the FUTA tax with an authorized financial institution or a Federal Reserve bank within one month following the close of the quarter. If the amount is $100 or less, you do not have to deposit it, but you must add it to the amount subject to deposit for the next quarter. To help ensure proper crediting to your account, write your employer identification number, "Form 940," and the tax period the deposit applies to on your check or money order.

Making deposits. The rules for depositing FUTA tax are the same as those discussed earlier for depositing social security and withheld income taxes. See *How to make deposits*, earlier.

Form 940. An annual return must be filed on Form 940 by January 31 following the close of the calendar year for which the tax is due. Any tax still due is payable with the return. You must file Form 940 on a calendar-year basis even if you operate on a fiscal-year basis.

Form 940 may be filed as late as February 10 following the close of the year if all required deposits were made timely and full payment of the tax is deposited by January 31. Also see *Penalties*, earlier.

Usually, the IRS will mail copies of Form 940 to you. However, if you do not receive them, you may order them from the IRS Forms Distribution Center.

Form 940–EZ. Form 940–EZ, a simplified version of Form 940, can be used by small employers: (1) who paid state unemployment taxes to only one state; (2) who paid the state taxes by the due date of Form 940–EZ and (3) whose wages taxable for FUTA tax were also taxable for state unemployment tax.

Additional Information. More information on the federal unemployment tax can be found in the instructions on Form 940. If you need information on whether you are subject to income tax withholding, social security taxes, or the federal unemployment tax, see the chart in Circular A (Publication 51).

Crew Leaders

Farmers may use the services of, or employ, individuals called crew leaders to provide them with farm labor.

Social security tax. For social security tax purposes, the crew leader is considered the employer of the workers if the crew leader:

1) Furnishes workers to do farm labor; and
2) Pays (either on his or her behalf or on behalf of the farmer) the workers furnished by him or her for the farm labor done by them; and
3) Has not entered into a written agreement with the farmer under which he or she is designated as an employee of the farmer.

Federal unemployment tax. For federal unemployment tax purposes, the crew leader is considered the employer of the workers if, in addition to the above requirements:

1) The crew leader is registered under the Farm Labor Contractor Registration Act, or
2) Substantially all members of the crew operate or maintain mechanized equipment provided by the crew leader as part of the service to the farmer.

The farmer is considered the employer of the workers in all situations not covered above. In addition, the farmer is considered the employer of workers furnished by a registered crew leader if the workers are the employees of the farmer under the common-law test. For example, some farmers employ individuals to recruit farm workers exclusively for them. Although these individuals may be required to register under the Farm Labor Contractor Registration Act, the workers are employed directly by the farmer. The farmer is considered to be the employer in these cases. For information concerning who is a common-law employee, see *Who Are Employees?* in Publication 937, *Business Reporting*.

Advance Payment of Earned Income Credit

Employers are generally required to make payments to employees who have filed with them a Form W–5, *Earned Income Credit Advance Payment Certificate*, to receive advance payments of their earned income credit. This allows those employees to receive the benefit of their credit each payday rather than having a single amount credited to them later on their tax return. Employers of farm workers do not have to make advance payments to farm workers paid on a daily basis.

The payment is added to the pay of the employees each payday. It is figured from tables in Circular E, *Employer's Tax Guide*. Employers reduce their liability for income tax withholding and social security taxes by the total amount of the advance earned income credit payments made. For more information, see *Advance Payment of Earned Income Credit* in Publication 937.

Earned income credit notification. You are required to notify each employee who worked for you at any time during the year and from whom you did not withhold any income tax about the earned income credit (EIC). However, you do not have to notify employees who have claimed exemption from withholding on Form W–4, *Employee's Withholding Allowance Certificate*.

You can meet the ***notification requirement*** by giving each employee the official IRS Form W–2, *Wage and Tax Statement*, which contains the notification on the back of Copy C, or you can give each employee Notice 797, *Notice of Possible Federal Tax Refund Due to the Earned Income Credit (EIC)*. You can also use your own written statement as long as it has the exact wording of Notice 797, or you can furnish substitute Forms W–2 containing the exact wording shown on the back of Copy C of the official Form W–2. You must so notify each employee, either in person or by first class mail, with his or her 1990 Form W–2 or within one week before or after that time, unless you use a substitute Form W–2 as the notice. If you do not furnish Form W–2 on time, you must notify the employee about the EIC by the date Form W-2 was required to be furnished. If Form W-2 is not required, you must notify the employee about the EIC by February 7, 1991.

You can request supplies of Notice 797 by calling the IRS toll-free telephone number 1-800-TAX-FORM (1-800-829-3676).

17. Excise Taxes

You may be eligible to claim a credit for federal excise tax paid on gasoline or special motor fuels used on a farm for farming purposes. You may also be eligible to claim a credit or refund for:

- Diesel fuel and aviation fuel used on a farm for farming purposes,
- Gasoline and diesel fuel used in off-highway business uses, or
- Diesel fuel used for any reason in boats and stationary motors.

Also, you may be eligible to claim a one-time credit or refund as the ***original*** purchaser of a diesel-powered car, van, or light truck.

You may be able to buy diesel fuel tax free instead of buying the fuel tax paid and then filing for a credit or refund. See *How To Buy Diesel Fuel Tax Free*, later.

For information about other excise tax credits and refunds available to other professions, see Publication 378, *Fuel Tax Credits and Refunds*.

Fuels Used on a Farm for Farming Purposes

You may be eligible to claim a credit or refund of excise taxes included in the price of fuel used on a farm for farming purposes if you are the owner, tenant, or operator of a farm. You may claim ***only*** a credit for gasoline and special motor fuel used on a farm for farming purposes. You may claim either a credit or refund for diesel fuel and aviation fuel used on a farm for farming purposes.

Farm. A farm includes livestock (including feed yards for fattening cattle), dairy, fish, poultry, fruit, fur-bearing animals, truck farms, orchards, plantations, ranches, nurseries, ranges, and structures such as greenhouses used primarily for raising agricultural or horticultural commodities. A fish farm is an area where fish are grown or raised — not merely caught or harvested. The farm must be operated for profit and located in any of the 50 States or the District of Columbia.

Farming purposes. Fuel is used on a farm for farming purposes if it is used:

1) To cultivate the soil, raise or harvest any agricultural or horticultural commodity.
2) To raise, shear, feed, care for, train or manage livestock, bees, poultry, fur-bearing animals, or wildlife.
3) To operate, manage, conserve, improve, or maintain your farm, tools, or equipment.
4) To handle, dry, pack, grade, or store any raw agricultural or horticultural commodity (as provided below).
5) To plant, cultivate, care for, or cut trees, or to prepare (other than the sawing into lumber, the chipping or other milling) trees for market, but only if the planting, etc., is incidental to your farming operations (as provided below).

Fuel is used on a farm for farming when it is used by you to handle, dry, pack, grade, or store a raw commodity, but only if you produced more than one-half of the commodity which was so treated during the taxable year for which you are making a claim. Commodity refers to a single raw product. For example, apples would be one commodity, and peaches another. The more than one-half test applies separately to each commodity.

Fuel used in incidental tree operations on your farm may not be included in a claim unless the operations are minor in nature when compared to the total farming operations.

Fuel used on a farm for farming purposes includes fuel used by you as the owner, tenant, or operator, and fuel used by a neighbor or a custom operator who performs services for you to cultivate the soil, raise or harvest any agricultural or horticultural commodity, or to raise, shear, feed, care for, train or manage livestock, bees, poultry, fur-bearing animals, or wildlife.

If you have any person perform any other services for you on your farm, no one can claim the credit for fuel used on a farm for farming purposes for these services.

Example 1. Farm owner Nancy Blue hired custom operator Harry Steele to cultivate the soil on the Blue's farm in preparation for planting. Under the contract, Nancy paid for 200 gallons of gasoline to be used by Harry on the farm. In addition, Nancy hired Farmer Brown to grade and pack Nancy's apple crop. Brown purchased 25 gallons of gasoline to use in packing the apples and was not reimbursed by Nancy. Nancy may claim the 200 gallons of gasoline used by Harry on Nancy's farm because it qualifies as fuel used on the farm for farming purposes. No one can claim a credit for the 25 gallons.

If there is doubt whether fuel was purchased by the owner, tenant, or the operator of the farm, determine who actually bore the cost of the fuel. Also, if you sell fuel to a neighbor who uses it on a farm for farming purposes, your neighbor (not you) can claim the credit on the fuel you sold, because your neighbor bore the cost of the fuel.

Example 2. Mr. Green, the owner of the farm, and his tenant, Mr. Smith, share the cost of the fuel used on the farm 50-50, so each can claim a credit for the tax on one-half the fuel used.

Cropdusting. The use of fuel in the aerial or other application of fertilizers, pesticides, or other substances is a use of fuel on a farm for farming purposes. You as the owner, tenant, or operator may claim the credit or refund. If you do not file a claim, you may waive your right to the claim and then, the claim can be made by the applicator. The applicator is treated as having used the fuel on a farm for farming purposes.

The waiver. To waive your right to the credit or refund, you must:

1) Execute in writing an irrevocable statement that you knowingly give up your right to the credit or refund.
2) Identify clearly the time period that the waiver covers. The effective period of your waiver cannot extend beyond the last day of your tax year.
3) Sign the waiver before the applicator files his or her claim. Once signed, the waiver cannot be revoked. You may authorize an agent, such as a cooperative, to sign the waiver for you.
4) Keep a copy of the waiver for your records and give a copy of the signed waiver to the applicator. Do ***not*** send this waiver to the Internal Revenue Service, unless requested to do so.

The waiver may be a separate document or it may appear on an invoice or another document from the applicator. If the waiver appears on an invoice or other document, it must be printed in a section clearly set off from all other material, and it must be printed in type sufficiently large to put you on notice that you are waiving your right to the credit or refund. In addition, if the waiver appears as part of an invoice or other document, it must be written separately from any other item that requires your signature.

Sample form of waiver. While no specific form is required, an acceptable statement wa your right to claim a credit or refund follows:

I hereby waive my right as owner, tenant, operator of
farm located at
(address)____________________
to receive credit or refund for fuel used by
(name of
applicator)____________________
on the farm in connection with cultivating the soil, or
raising or harvesting of any agricultural or horticultu
commodity.
This waiver applies to fuel used during the period,
____________________, both dates inclusive.
I understand that by signing this waiver, I give up my
to claim any credit or refund for fuel used by the a
applicator or other applicator of fertilizer or other
substances during the period indicated, and I
acknowledge that I have not previously claimed an
credit for that fuel.
(Signature of the owner/tenant/operator)____________________
Date____________________

Sign a separate waiver for each tax year or of a tax year in which the fuel was used. If any part of the waiver period extends beyond the of the applicator's tax year, the applicator mus wait until the next tax year to claim the credit o refund for that part.

Fuel not used for farming. Fuel is not used farming purposes when used:

1) Off the farm, such as on the highway or in noncommercial aviation, even though the is used in transporting livestock, feed, crop or equipment;
2) For personal use, such as mowing the law
3) In processing, packaging, freezing, or can operations; or
4) In the processing of crude gum into gum spirits of turpentine or gum resin, or in the processing of maple sap into maple syrup maple sugar.

Fuels Used In Off-Highway Business Use

In addition to claims for excise paid on fuels u on a farm for farming purposes, you may be el ble to claim a credit or refund for fuels used in highway business use.

Off-highway business use. Off-highway bu ness use of fuel is any use in a trade or busine or in any income-producing activity. The use m not be in a highway vehicle registered for use public highways. Off-highway business use do not include any use in a motorboat.

Highway vehicle. Highway vehicle include any self-propelled vehicle designed to carry a over public highways, whether or not also designed to perform other functions. It does n matter if the vehicle is designed to perform a h way transportation function for only a particula type of load, such as passengers, furnishings, personal effects (as in a house, office, or utility trailer), or a special kind of cargo, goods, supp or materials. It does not matter if machinery or equipment is specially designed (and permane mounted) to perform some off-highway task unrelated to highway transportation except to extent discussed in the next paragraph. Examp of vehicles that are designed to carry a load o public highways are passenger automobiles, motorcycles, buses, highway-type trucks, and truck tractors.

Vehicles not considered highway vehicles. enerally, the following kinds of vehicles are not nsidered highway vehicles:

- Specially designed mobile machinery for nontransportation functions. A self-propelled vehicle is not a highway vehicle if the chassis—
  - a) Has permanently mounted to it machinery or equipment used to perform certain operations (construction, manufacturing, drilling, mining, timbering, processing, farming, or operations similar to any of these) if the operation of the machinery or equipment is unrelated to transportation on or off the public highways,
  - b) Has been specially designed to serve only as a mobile carriage and mount for the machinery or equipment, whether or not the machinery or equipment is in operation, and
  - c) Could not be used, because of its special design, as part of a vehicle designed to carry any other load without substantial structural modification.
- Vehicles designed for off-highway transportation. A self-propelled vehicle is not a highway vehicle if—
  - a) The vehicle is designed primarily to carry a specific kind of load other than over the public highway for certain operations (construction, manufacturing, mining, processing, farming, drilling, timbering, or similar operations), and
  - b) The vehicle's use of carrying this load over public highways is substantially limited or impaired because of its design. For purposes of this requirement, account may be taken of whether the vehicle may travel at regular highway speeds, requires a special permit for highway use, or is overweight, overheight, or overwidth for regular highway use.

A ***diesel-powered highway vehicle*** is any highway vehicle that uses diesel fuel for propulsion.

A ***public highway*** includes any road (federal or state highway, or city street) in the United States that is not a private roadway.

Registered. A vehicle is considered registered when it is:

1) Registered for highway use under the law of any state, the District of Columbia, or any foreign country, or
2) Required to be registered for highway use under the law of any state, the District of Columbia, or any foreign country in which it is operated or situated.

Any highway vehicle operated under a dealer's tag, license, or permit is considered registered. A highway vehicle is not considered registered solely because there has been issued a special permit for operation of the vehicle at particular times and under specified conditions.

Fuel used in power take-offs. A credit or refund is not allowed for fuel used in the motor of a highway vehicle that also operates special equipment by means of a power take-off or power transfer. It does not matter if the special equipment is mounted on the vehicle. For example, there is no credit or refund on gasoline used to operate the mixing unit on a concrete-mixer truck when the mixing unit is operated by a power take-off from the motor of the vehicle. Similarly, fuel used in the motor of a fuel-oil delivery truck to operate the pump on the truck for discharging the fuel into the customer's storage tank does not qualify for a credit or refund of tax.

If a registered highway vehicle is equipped with a separate motor to operate the special equipment, such as a refrigeration unit, pump, generator, or mixing unit, the fuel used in the separate motor qualifies. When fuel is drawn from the same tank that supplies fuel for propelling the vehicle, you must figure the quantity used in the separate motor operating the special equipment. Your reasonable estimate of the amount of fuel used will be accepted for a credit or a refund. The figure must be based, however, on operating experience and supported by your records. Devices to measure the number of miles the vehicle has traveled, such as hubometers, may be used to figure the number of gallons of fuel used to propel the vehicle. Add to this amount the fuel consumed while idling or warming up the motor preparatory to propelling the vehicle.

Fuel lost or destroyed through spillage, fire, or other casualty is not treated as fuel used in an off-highway business use.

Fuels used in stationary machines such as generators, compressors, power saws, and similar equipment; for cleaning purposes; in forklift trucks and bulldozers; and in cars and trucks operating off the highway in construction, mining, or timbering activities, if the vehicles are neither registered nor required to be registered, are examples of fuels used in off-highway business uses.

Diesel Fuel Used for Nontaxable Purposes

In addition to claims for excise taxes paid on fuels used on a farm for farming purposes and on fuels used in off-highway business use, you may be eligible to claim a credit or refund for tax-paid diesel fuel used for nontaxable purposes. Nontaxable uses of diesel fuel include both business and personal uses of diesel fuel in boats, nonhighway vehicles, and stationary motors.

How To Buy Diesel Fuel Tax Free

You may be eligible to buy diesel fuel tax free for the following purposes:

1) On a farm for farming purposes,
2) In an off-highway use such as use in a bulldozer, forklift, or other nonhighway vehicle,
3) In any boat,
4) In stationary machines such as generators, compressors, or similar equipment.

In order to buy diesel fuel tax free, you must buy from a supplier that is registered with the IRS to sell diesel fuel tax free.

Although you do not have to be registered with the IRS to buy diesel fuel tax free, you must give your supplier a signed exemption certificate that states your name, address, taxpayer identification number (TIN), and intended nontaxable use.

Exemption certificate. The following is an acceptable exemption certificate:

Date______________________________

The undersigned buyer ("Buyer") hereby certifies that: (check applicable type of certificate)

_______________The diesel fuel specified in the accompanying order or on the reverse side hereof, or

_______________The (quantity)____________ of diesel fuel ordered by the Buyer

for the period beginning on (Date) _______________ and ending on (Date)_______________(the period cannot exceed 12 calendar months) will be used for (state intended nontaxable use, such as use on a farm for farming purposes, etc.)

____

If this diesel fuel is resold or used for a purpose other than as stated in this certificate, then Buyer may be subject to tax.

Buyer will be prepared to establish by satisfactory evidence the purpose for which Buyer used the product bought under this certificate.

Buyer understands that any fraudulent use of this certificate to buy any diesel fuel free of tax may subject Buyer to penalties of perjury, which may include fine or imprisonment.

TIN______________________________

Signature____________________________

Title______________________________

Address____________________________

The information required by the exemption certificate may be transmitted from you to your supplier by any convenient means and may be preprinted on any business form normally used by you to transfer information to your supplier. You may give a separate exemption certificate for each purchase or you may use one certificate to cover all purchases from a particular seller for up to a year.

Buyers who use diesel fuel for both taxable and nontaxable purposes may buy tax free only the amount of diesel fuel that they can reasonably project at the time of purchase to use for nontaxable purposes.

Gasoline. Your supplier may not sell you gasoline tax-free for any purpose.

Diesel-Powered Cars, Vans, and Light Trucks

If you bought a qualified diesel-powered highway vehicle, you may be eligible for a one-time credit or refund. You claim the credit on the tax return for the year of purchase. To see if you are eligible to use Form 843, *Claim for Refund and Request for Abatement*, to claim a refund for the purchase of a diesel-powered highway vehicle, read *How To Claim a Credit or Refund*, later.

Qualified diesel-powered vehicle. A qualified diesel-powered highway vehicle is one that:

1) Has at least four wheels,
2) Has a gross vehicle weight rating of 10,000 pounds or less, and
3) Is registered for highway use in the United States under the laws of any state.

Original purchaser. You must be the original purchaser. An original purchaser is the first person to buy a new qualified diesel-powered vehicle after January 1, 1985, for use other than resale.

Amount of credit or refund. The credit or refund for 1984–1993 models is $102 for a car, and $198 for a light truck or van. A van is a vehicle with no body sections protruding more than 30 inches ahead of the leading edge of the windshield.

Basis reduction. The basis of any qualified diesel-powered highway vehicle must be reduced by the amount of credit or refund payable for such vehicle. The basis reduction is considered to occur on the date of purchase.

Example. In 1990, you purchased a new diesel-powered truck for $9,198. The $198 credit or refund can be claimed only for the tax year in which you purchased the truck (1990). The basis of your truck is reduced by $198 to $9,000 on the date you purchased it.

How To Claim a Credit or Refund

If you purchase the fuel tax paid and you use it for farming purposes, you generally can claim a credit or refund of the excise taxes included. You can claim only a credit for gasoline and special motor fuel used for farming purposes. You can claim either a credit or a refund for diesel fuel and aviation fuel used for farming purposes.

No credit or refund is allowed to anyone for any fuel purchased tax free.

Taxpayer identification number. To file a claim for credit or refund, you must have a taxpayer identification number — either a social security number or an employer identification number. See *Identification number* in *Filing Requirements*.

Recordkeeping. You must keep at your principal place of business records that will allow the IRS to verify the amount claimed. No special form is required, but the records should show:

1) The total number of gallons purchased and used during the period covered by your claim,
2) The dates of the purchases,
3) The names and addresses of suppliers and amounts purchased from each during the period covered by your claim,
4) The purpose for which the fuel was used, and
5) The number of gallons used for each purpose.

It is important that your records show separately the number of gallons used for each purpose that qualifies as a claim. Do ***not*** submit copies of vouchers or checks showing the purchase of and payment for fuels for which you claim a credit or file a claim for refund.

Amount of credit or refund. The rate of tax imposed on fuels changed during 1990. Before September 1, 1990, the rate of tax included the Leaking Underground Storage (LUST) tax. After August 31, 1990, the rate of tax does not include the LUST tax. The rate of tax shown on your record of sale determines the amount of credit or refund you may claim.

The rate of tax before September 1, 1990 was:

- Gasoline: 9.1 cents
- Gasohol: 3.1 cents
- Diesel fuel: 15.1 cents
- Special motor fuels: 9.1 cents
- Gasoline used in aviation: 12.0 cents or 9.0 cents
- Aviation fuels (other than gasoline): 14.0 cents

The rate of tax after August 31, 1990 is:

- Gasoline: 9.0 cents
- Gasohol: 3.0 cents
- Diesel fuel: 15.0 cents
- Special motor fuels: 9.0 cents
- Gasoline used in aviation: 12.0 cents or 9.0 cents
- Aviation fuels (other than gasoline): 14.0 cents

Caution: At the time this publication went to print, Congress was considering legislation that will increase the excise tax on gasoline and restore the 0.1 cent a gallon LUST tax. For more information on this tax and other tax law changes, see Publication 553, *Highlights of 1990 Tax Changes*.

Claiming a Credit

A claim for credit is made on Form 4136, *Credit for Federal Tax on Fuels*, and attached to your income tax return. Do not claim a credit on Form 4136 for any excise tax for which you have already filed a refund claim on Form 843.

How to claim a credit. How you claim a credit depends on whether you are an individual, partnership, corporation, S corporation, trust, or farmers' cooperative association.

Individuals. Individuals claim the credit on line 60 of the 1990 Form 1040. Even though you may not otherwise have to file an income tax return, you must do so to obtain a fuel tax credit. See instructions accompanying Form 1040.

Partnerships. Partnerships cannot claim the credit on Form 1065, *U.S. Partnership Return of Income*. A partnership must attach a statement to Form 1065, showing the number of gallons of each fuel used and allocating the gallons to each partner according to the percentage of the partnership owned. Each partner then claims the credit on his or her income tax return for his or her share of the fuel used by the partnership.

Corporations. Corporations use line 32g of Form 1120, *U.S. Corporation Income Tax Return*, or line 23c of Form 1120–A, *U.S. Corporation Short-Form Income Tax Return*, to claim the credit.

S corporations. S corporations use line 23c of Form 1120S, *U.S. Income Tax Return for an S Corporation*, to claim the credit.

Farmers' cooperative associations required to file Form 990–C, *Farmers' Cooperative Association Income Tax Return*, use line 32g to claim the credit or refund.

Trusts. Trusts use line 24g of Form 1041, *U.S. Fiduciary Income Tax Return*, to claim the credit.

When to claim a credit. You can claim a fuel tax credit on your income tax return for the year the fuels were used or on an amended return for credit filed within the time prescribed by law. Ordinarily, you have the later of 3 years from the date your original return was filed (a return filed early is considered filed on the due date) or 2 years from the time the tax was paid.

Claiming a Refund

A claim for refund is filed on Form 843. You may be eligible to claim a refund during 1991 rather than waiting to file your 1991 income tax return to claim a credit. However, only a credit can be claimed for excise tax on gasoline and special motor fuel used on a farm for farming purposes.

The claim must include a statement showing:

1) The total number of gallons used (during the period covered by your claim) multiplied by the appropriate rate of tax,
2) The purpose or purposes (for example, the off-highway business use) for which the fuels were used,
3) The amount used for each purpose (a list of uses by general categories will do), and
4) The Internal Revenue Service Center where you filed your last income tax return (if applicable).

Quarterly refund claim. A quarterly refund claim can be filed for any of the first three quarters of your tax year for which you qualify. To qualify for a quarterly refund, you must be claiming:

1) At least $1,000 for gasoline used for nontaxable purposes such as off-highway business use during the quarter,
2) At least $1,000 for special motor fuel used for nontaxable purposes such as off-highway business use during the quarter and for the credit for diesel-powered highway vehicles, or
3) At least $750 for diesel fuel or aviation fuel used for nontaxable purposes during the quarter.

Note: You cannot claim a refund of the
taxes paid on gasoline and special motor fu
used on a farm for farming purposes, althou
can claim a credit for the excise taxes paid o
gasoline and special motor fuels used on a
for farming purposes.

A special rule for diesel fuel and aviation
allows you to aggregate the amount of fuel
each quarter. If the amount of your claim is
than $750 in a quarter, but the amount of the
claim for more than one quarter is at least $7
you may file a claim for the quarter for which
combined total is at least $750.

Fourth quarter claims. You cannot file a
terly claim for refund for the fourth quarter of
tax year. Claims for the fourth quarter must be
filed as a credit on your income tax return.

When to file quarterly claim. You must file
quarterly claim by the last day of the third mo
following the end of the quarter for which the
claim is being filed. If the claim is late, a refun
not be allowed. Instead, the amount of disallo
refund is added to any claim for credit and cl
on your income tax return. Do not claim a cre
against your income tax for any excise tax for
which you filed a claim for refund.

Form 843 is filed in the same name and wi
same IRS Service Center where the latest in
tax return was filed. A partnership files a claim
refund in the name of the partnership, and on
the partners must sign it. A corporation files th
claim in the name of the corporation and one
officers must sign it.

Example 1. Farm owner Harry Jones repo
his income on the calendar year basis. In 199
used 20,000 gallons of gasoline on his farm fo
farming purposes. On his 1990 income tax ret
he claims a credit of $1,820 for gasoline again
his income tax liability. He cannot file a claim
refund for the gasoline excise tax.

Example 2. Pearl Steele used 15,000 gall
of tax-paid diesel fuel on her farm for farming
purposes in April of 1990. She filed Form 843
the second quarter of 1990 and claimed a $2,
refund for the diesel fuel excise tax included i
price of the fuel. When Pearl files her 1990
income tax return, she cannot claim a credit f
the 15,000 gallons of diesel fuel.

Including the Credi or Refund in Gross Income

Any credit or refund of excise taxes on fuels y
receive must be included in your gross incom
you claimed the taxes as an expense deducti
that reduced your income tax liability. Do not
include as income any credit or refund relate
the purchase of a qualified diesel-powered hi
way vehicle.

The year a credit or refund is includible in g
income depends on whether you use the cas
accrual method of accounting.

Cash-basis taxpayer. A cash-basis taxpaye
who files a claim for refund must include the
refund in gross income for the tax year in whi
the refund is received. A cash-basis taxpayer
claims a credit on an income tax return includ
the credit in gross income for the tax year in
the income tax return is filed. If an amended
is filed claiming credit for the tax, include the
refunded in gross income for the tax year in
it is received. For farmers, this amount is repo
on line 10 in Part I of Schedule F, *Farm Incon
and Expenses*.

Example. Ed Brown, a cash-basis farmer,
his 1990 Form 1040 on March 1, 1991. On Sc
ule F, Ed claimed $1,200 for gasoline that he

d on the farm. The $1,200 claimed as a deduction included the excise tax ($100). Then, on Form 36, Ed claimed the $100 of excise tax paid on gasoline as a credit. Ed must report the $100 additional income on his 1991 Schedule F.

crual-basis taxpayer. An accrual-basis tax- yer must include the entire amount of the claim gross income for the tax year in which the quali- ng use occurred. It does not matter if an crual-basis taxpayer filed for a quarterly refund claimed the entire amount as a credit. Farmers port the refund on line 44 in Part III of Schedule

Example. Todd Green, an accrual-basis rmer, filed his 1990 Form 1040 on April 15, 991. On Schedule F, he claimed $1,855 for gaso- e that he used on the farm during 1990. The 1,855 claimed as a deduction included the excise x of $155. Then, on Form 4136, he claimed the 155 excise tax paid on the gasoline as a credit. e reported the $155 as additional income on his 990 Schedule F.

18. The Examination and Appeals Process

We examine returns for correctness of income, emptions, credits, and deductions.

Fairness if Your Return is Examined

Most taxpayers' returns are accepted as filed. But if your return is selected for examination, it does not suggest that you are dishonest. The examination may or may not result in more tax. Your case may be closed without change. Or, you may receive a refund.

Courtesy and consideration. You are entitled to courteous and considerate treatment from IRS employees at all times. If you ever feel that you are not being treated with fairness, courtesy, and consideration by an IRS employee, you should tell the employee's supervisor. Publication 1, *Your Rights as a Taxpayer* explains the many rights you have as a taxpayer. You can get this publication free by calling us at our toll-free number.

Pay only the required tax. You have the right to plan your business and personal finances in such a way that you will pay the least tax that is due under the law. You are liable only for the correct amount of tax. Our purpose is to apply the law consistently and fairly to all taxpayers.

Privacy and confidentiality. You have the right to have your tax case kept confidential. Under the law, the IRS must protect the privacy of your tax information. However, if a lien or a lawsuit is filed, certain aspects of your tax case will become public record. People who prepare your return or represent you must also keep your information confidential.

You also have the right to know why we are asking you for information, exactly how we will use it and what might happen if you do not give it.

Examination of Returns

An examination usually begins when we notify you that your return has been selected. We will tell you which records you will need. If you gather your records before the examination, it can be completed with the least amount of effort.

How returns are selected. We select returns for examination by several methods. A computer program called the Discriminant Function System (DIF) is used to select most returns. In this method, the computer uses historical data to give parts of the return a score. IRS personnel then screen the return. Returns most likely to have mistakes are selected for examination.

Some returns are selected at random. We use these examination results to update and improve our selection process.

We also select returns by examining claims for credit or refund and by matching information documents, such as Forms W-2 and 1099, with returns.

Arranging the examination. Many examinations are handled by mail. For information on this, get Publication 1383, *The Correspondence Process (Income Tax Accounts)*, available free by calling our toll-free telephone number 1-800-TAX-FORM (1-800-829-3676). If we notify you that your examination is to be conducted through a personal interview, or if you request such an interview, you have the right to ask that the examination take place at a reasonable time and place that is convenient for both you and the IRS. If the time or place we suggest is not convenient, the examiner will try to work out something more suitable. However, we will make the final determination on how, when, and where an examination takes place.

Transfers to another district. Generally, your return is examined in the IRS district where you live. But if it can be examined more quickly and conveniently in another district, such as where your books and records are located, you may ask to have the case transferred to that district.

Representation. Throughout the examination, you may represent yourself, have someone else accompany you, or, with proper written authorization, have someone represent you in your absence. If you want to consult an attorney, C.P.A., an enrolled agent, or any other person permitted to represent a taxpayer during an examination, we will stop and reschedule the interview. We cannot suspend the interview if you are there because of an administrative summons.

Recordings. You can generally make an audio recording of an interview with an IRS Examination officer. Your request to record the interview should be made in writing. You must notify us 10 days before the meeting and bring your own recording equipment. We also can record an interview. If we initiate the recording, we will notify you 10 days before the meeting and you can get a copy of the recording at your expense.

Repeat examinations. We try to avoid repeat examinations of the same items, but sometimes this happens. If we examined your tax return for the same items in either of the 2 previous years and proposed no change to your tax liability, please contact us as soon as possible so that we can see if we should discontinue the examination.

Explanation of Changes

If we propose any changes to your return, we will explain the reasons for the changes. It is important that you understand the reasons for any proposed change. You should not hesitate to ask about anything that is unclear to you.

Agreement with changes. If you agree with the proposed changes, you may sign an agreement form and pay any additional tax you may owe. You must pay interest on any additional tax. If you pay when you sign the agreement, the interest is generally figured from the due date of your return to the date you paid.

If you do not pay the additional tax when you sign the agreement, you will receive a bill. The interest on the additional tax is generally figured from the due date of your return to the billing date. However, you will not be billed for more than 30 days additional interest, even if the bill is delayed. Also, you will not have to pay any more interest or penalties if you pay the amount due within 10 days of the billing date.

If you are due a refund, we can refund your money more quickly if you sign the agreement form. You will be paid interest on the refund.

Appealing the Examination Findings

If you do not agree with the examiner's report, you may meet with the examiner's supervisor to discuss your case further. If you still don't agree with the examiner's findings, you have the right to appeal them. The examiner will explain your appeal rights and give you a copy of Publication 5, *Appeal Rights and Preparation of Protests for Unagreed Cases*. This publication explains your appeal rights in detail and tells you exactly what to do if you want to appeal. You can also get a free copy by calling us at our toll-free number.

Appeals Office. You can appeal the findings of an examination within the IRS through our Appeals Office. The Appeals Office is independent of your examiner and IRS District Director or Service Center Director. Most differences can be settled through this appeals system without expensive and time-consuming court trials. If the matter cannot be settled to your satisfaction in Appeals, you can take your case to court.

Appeals to the courts. Depending on whether you first pay the disputed tax, you can take your case to the U.S. Tax Court, the U.S. Claims Court, or your U.S. District Court. These courts are entirely independent of the IRS. However, a U.S. Tax Court case is generally reviewed by our Appeals Office before it is heard by the Tax Court. As always, you can represent yourself or have someone admitted to practice before the court represent you.

If you did not yet pay the additional tax and you disagree about whether you owe it, you generally have the right to take your case to the Tax Court. Ordinarily you have 90 days from the time we mail you a formal notice (called a "notice of deficiency") telling you that you owe additional tax to file a petition with the Tax Court.

If you have already paid the disputed tax in full and filed a claim for refund (discussed later) for it that we disallowed (or on which we did not take action within 6 months), then you may take your case to the U.S. District Court or U.S. Claims Court.

Court decisions. We follow Supreme Court decisions. However, we can lose cases in other courts involving taxpayers with the same issue and still apply our interpretation of the law to your situation. You have the right to appeal our decision to do so.

Recovering litigation expenses. If the court agrees with you on most of the issues in your case, and finds the IRS's position to be largely unjustified, you may be able to recover some of your litigation expenses from us. But to do this, you must have used up all the administrative remedies available to you within the IRS, including going through our Appeals system. You may also be able to recover administrative expenses from the IRS.

Publication 556, *Examination of Returns, Appeal Rights, and Claims for Refund*, will help you more fully understand your appeal rights. You can get it free by calling our toll-free number.

Other Remedies

If you believe that tax, penalty, or interest was unjustly charged, you have rights which can remedy the situation.

Claims for refund. Once you have paid your tax, you have the right to file a claim for a credit or refund if you believe the tax is too much. You may claim a credit or refund by filing Form 1040X, *Amended U.S. Individual Income Tax Return.*

You should file your claim by mailing it to the Internal Revenue Service Center where you filed your original return. File a separate form for each year or period involved.

Time for filing a claim. Claims for a credit or refund must be filed within 3 years from the date you filed your original return or 2 years from the date you paid the tax, whichever is later. There are exceptions to this time period if your claim is based on certain carryback items, foreign taxes, bad debts, worthless securities, or if you and the Service have agreed to extend the tax assessment period.

Cancellation of penalties. You have the right to ask that certain penalties (but not interest, as discussed later) be canceled (abated) if you can show reasonable cause for the failure that led to the penalty (or can show that you exercised due diligence, if that is the applicable standard for the penalty).

If you relied on wrong advice given to you by IRS employees on the toll-free telephone system, we will cancel certain penalties that may result. But you have to show that your reliance on the advice was reasonable.

Reduction of interest. If our error caused a delay in your case, and this is grossly unfair, you may be entitled to a reduction of the interest which would otherwise be due. Only delays caused by procedural or mechanical acts that do not involve exercising judgment or discretion qualify. If you think we caused such a delay, please discuss it with the examiner and file a claim.

Business Taxpayers

If you are in an individual business, the rights covered in this discussion generally apply to you. If you are a member of a partnership or a shareholder in a small business corporation, special rules (which may be different from those described here) may apply to the examination of your partnership or corporation items. The examination of these items is discussed in Publication 556, *Examination of Returns, Appeal Rights, and Claims for Refund.* You can get this publication free by calling us at our toll-free number.

19. Sample Return

This sample return uses actual return forms to show you how to prepare your income tax return. The instruction references on the forms refer to the instructions for that form, not to this chapter. The information shown on the filled-in forms is not from any actual farming operation.

This return has been prepared on the cash method. See Chapter 3 for an explanation of the cash method and other methods of accounting.

You may round off cents to the nearest whole dollar on your return and schedules. To do so, drop amounts under 50 cents and increase amounts from 50 to 99 cents to the next dollar. For example, $1.39 becomes $1 and $2.50 becomes $3.

If you do round off, do so for all amounts. However, if you have to add two or more amounts to figure the total to enter on a line, include cents when adding the amounts and only round off the total.

Receipts and expenses records. The receipts and expenses records shown in this chapter are limited to a few farm account entries made at the beginning of the tax year. The totals, however, include all of Mr. Brown's receipts and expenses for 1990.

Each entry for an income item shows the date and from whom it was received, as well as the amount and kind of income. Each expense entry shows the date of payment, to whom paid, and whether it was a business expense or an investment in new property.

Depreciation records. The depreciation records in this chapter give Mr. Brown a record of his depreciable property. They show the depreciation for each year and the investment credit.

You are not required to use these particular forms of records. These illustrations are not the only way records can be kept. They are used only to show a simple way to keep farm records. The Cooperative Extension Service can provide you with more information on farm record systems.

Preparing the Return

Schedule F (Form 1040)

The first step in preparing a farmer's income tax return is to determine net farm profit or loss on Schedule F. The income and expenses shown on this Schedule F are taken from Mr. Brown's farm receipt and expense records. The depreciation deduction is taken from the illustrated depreciation records. Farm income is discussed in Chapter 4, and farm expenses are discussed in Chapter 5. Mr. Brown has filed all required Form 1099 information returns.

Schedule F—Income

Mr. Brown prints his name and social security number as shown on the address label at the top of Schedule F. He writes his principal product, "MILK," on line A. On line B, to the right, *Agricultural Activity Code,* he writes the number "240" from the list of *Principal Agricultural Activity Codes* printed on page 2 of Schedule F (not shown). This indicates that his principal source of farm income is dairy farming.

On line C, Mr. Brown checks the box next to *Cash* to indicate what method of accounting he uses. He also enters his employer identification number on line D. He checks the "Yes" box on line E to show that he has elected in a previous year to include Commodity Credit Corporation (CCC) loans in income. He checks the "Yes" box on line F to show that he materially participated in the operation of his farm business. On line G, he checks the "Does not apply" box to show he is choosing to revoke the election previously made to currently deduct his preproductive period expenses and not to have the uniform capitalization rules apply. He reports his farm income in Part I of Schedule F.

Line Items. Mr. Brown then fills in all applicable items of farm income.

Line 1. In 1990, Mr. Brown sold steers he had bought for resale. He enters the amount of the sales, $12,960, on line 1.

Line 2. On line 2, he enters the cost of the animals, $3,180.

Line 3. Mr. Brown subtracts his cost on line 2 from the sales on line 1 and reports the difference, $9,780, as his profit on line 3. He has
kept a record of the cost of the livestock h
bought and is careful to deduct the cost of
animal in the year of its sale. The cost of t
steers sold in 1990 is different from that sh
the farm expense record because most of
steers sold in 1990 were bought in 1989. H
sold any other items he bought for resale,
grain, he would combine the sales and cos
these items with the sales and costs of the
and report only the totals for all the items
1, 2, and 3. He does not report sales of an
held for draft, dairy, breeding, or sport her
sales are reported on Form 4797.

Line 4. On line 4, Mr. Brown reports th
of all income he received during 1990 from
of items he raised or produced on his farm
principal source of farm income is dairy fa
and the amount reported on this line, $10
includes $80,121 from sales of milk. Expe
deducted from the gross milk proceeds, s
hauling, advertising, and dues, are include
farm expenses in Part II of Schedule F.

He also received income from sales of
items raised or produced on his farm. He
$2,503 from the sale of steers and calves
raised. He grew some vegetables and sol
for $783. In addition, he includes in the to
this line his sales of corn, hay, and wheat
raised. He received $7,050 for the corn, $
the hay, and $7,892 for the wheat.

Lines 5a and 5b. He reports on line 5
$33 of patronage dividends received from
atives. He enters the $33, the amount of h
patronage dividends that are taxable, on l
See Chapter 4.

Lines 6a and 6b. Mr. Brown received
cost sharing of $438 on a soil conservatio
completed in 1990. The income was rece
materials and services paid for by the gov
and is reported on both line 6a and line 6
amount is reported to the Internal Revenu
Service (IRS), generally on Form 1099–G,
Department of Agriculture (USDA). All the
has been included on line 14 of Schedule
conservation expense. He did not receive
cost-sharing payments this year that he c
exclude from his farm income. See Chapt

Line 7a. On line 7a, Mr. Brown reporte
$665 loan he received from the CCC, sinc
elected in a previous year to treat these l
income in the year received. (If he had el
to report his CCC loan as income in the y
received, but forfeited the loan in a later y
would report the loan as income in the ye
feiture.) See Chapter 4.

Line 9. Mr. Brown reports on line 9 his
income from custom harvesting.

Line 10. He had claimed a gasoline ta
of $142 on his 1989 federal income tax re
includes the entire $142 in his 1990 incom
line 10, since that amount was included in
of the gasoline he had deducted as a farm
ness expense in 1989. He also includes $
received as a director of the local milk ma
cooperative and $175 received for firewo
Browns cut and sold in 1990.

Line 11—Gross Income. On line 11,
Brown enters $119,340, the total of the a
shown on lines 3, 4, 5b, 6b, 7a, 9, and 10.

Schedule F—Expenses

Mr. Brown keeps his farm expense recor
the year and summarizes all his farm exp
the end of the year. As a result, he has a
all his deductible farm expenses. These a
figures he enters in Part II of Schedule F.
expenses are listed on Schedule F in alp
order.

ne Items. Mr. Brown then fills in all applicable ms of farm expense deductions.

Line 12. On line 12, he enters the $746 he id for breeding fees.

Line 13. The $2,701 on line 13 is the amount e paid for pesticides and herbicides that were pplied to his crops and land.

Line 14. Mr. Brown deducts on line 14 the 1,040 spent on diversion channels in 1990. The mount listed here includes the full cost of the overnment cost-sharing project. He continues e policy elected in previous years of deducting nnual soil and water conservation expenses. The xpenses are consistent with a plan approved by he Soil Conservation Service of the USDA. Since he amount was not more than 25% of Mr. Brown's gross income from farming, the entire mount is deductible. He must complete and ttach Form 8645, *Soil and Water Conservation Plan Certification* (not shown). See Chapter 6.

Line 15. The $1,575 on line 15 is the amount he paid someone else for spraying his crops.

Line 16. On line 16, Mr. Brown enters the $21,867 depreciation from Form 4562.

Line 18. On line 18, he enters the cost of feed bought to feed livestock, $18,226. He did not include the cost of feed bought for livestock intended for consumption by himself and his family.

Line 19. Mr. Brown enters $6,544 on line 19. This is the amount he paid for fertilizer and lime.

Line 20. On line 20, he deducts the $3,072 he paid for trucking and milk marketing expenses. He chose to itemize the $807 government milk assessment and lists it separately on line 34a.

Line 21. Mr. Brown deducts on line 21 the $5,233 cost of gasoline, fuel, and oil bought for farm use. He did not deduct the cost of fuel used for heating, lighting, or cooking in his home to the extent they were used for himself and his family. He did not include the part of the cost of gasoline and oil used in his personal car for nonfarm use.

Line 22. On line 22, he deducts the $1,580 cost of insurance on his farm buildings (but not on his home), equipment, livestock, crops, and 60% of the cost of insurance on the car used 60% in farming. He did not deduct the entire premiums on 3-year and 5-year insurance policies in the year of payment, but deducts each year only the part that applies to that year. See Chapter 5.

Lines 23a and 23b. Mr. Brown deducts the $3,175 interest paid on the farm mortgage that applies to the land and buildings used in farming on line 23a. He deducts $1,043 interest paid on obligations incurred to buy livestock and other personal property used in farming or held for sale on line 23b. Interest on his home is deducted on Schedule A (Form 1040).

Line 24. On line 24, he enters the $16,416 in wages he paid during the year for labor hired to operate his farm business, including wages paid to Mrs. Brown and the children. He has no jobs credit. Not all the wages paid were subject to social security tax, but for those that were, he included the full amount of the wages before reduction for the employee's part of that tax. His part of the social security tax is included in the total taxes deducted on line 31.

Line 26b. Mr. Brown enters on line 26b only cash rent paid, $2,400, for the use of land he rented from a neighbor, Mr. Green. He did not deduct rent paid in crop shares. He completed a Form 1099–MISC for the rent paid to Mr. Green and filed Copy A with the IRS along with Form 1096. He gave Mr. Green Copy B of the Form 1099–MISC.

Line 27. The $5,424 he enters on line 27 includes $4,506 for repairs to farm machinery, $396 for the farm share of repairs to his car that was used 60% for business, and $522 for repairs to farm buildings. He did not include the value of his own labor. The payments for farm machinery repairs, although large, were made to a corporation, so he was not required to file a Form 1099 reporting these payments.

Line 28. Mr. Brown enters on line 28 the cost of seeds and plants used in farming, $2,132. He did not include the cost of plants and seeds purchased for the family garden.

Line 30. He enters on line 30 the $2,807 paid for livestock supplies and other supplies, including dairy and cattle supplies, bedding, and performance testing.

Line 31. On line 31, Mr. Brown enters $3,231 for taxes paid during 1990, including state and local taxes on the real estate and personal property used in farming. Sixty percent of the cost of his car tags was also included. He did not include the sales tax paid on farm supplies, or the 60% of the state gasoline tax applying to gasoline used in the family car for farm business, because these taxes were included in the deductions for supplies and gasoline. His share of social security tax for agricultural labor used on the farm for calendar year 1989, which he paid when he filed his Form 943 in January 1990, is included. He did not deduct his state income tax or taxes on his home, household furnishings, and other personal items on Schedule F. He deducts these taxes on Schedule A (Form 1040). He did not deduct any federal income tax paid during the year.

Line 32. He enters $3,997 on line 32 for the costs of water, electricity, and telephone used only in farming.

Line 33. Veterinary fees and livestock medicines paid for in 1990, $2,471, are entered on line 33.

Line 34. On line 34, Mr. Brown enters any other farm business expenses. These include $348 for commissions, dues, and fees, $287 for financial records and office supplies, and $534 for farm business travel. Farm business travel includes expenses for the State Beef Tour and for attendance at the farm management conference at State University.

Line 35—Total expenses. Mr. Brown adds the amounts shown on lines 12 through 34d and enters his total expenses of $107,656 on line 35.

Line 36—Net farm profit. To arrive at his net farm profit, he subtracts $107,656, line 35, from $119,340, line 11. His net farm profit, entered on line 36, is $11,684. He also enters that amount on line 19 of Form 1040, and on line 1 of Section A for Schedule SE (Form 1040). Since Mr. Brown shows a net profit on line 36, he skips line 37.

Form 4562—Depreciation

Mr. Brown records his depreciable property in a book that has provisions for figuring his depreciation allowance for several years. Part of his depreciation record book is shown in this chapter. That record book contains a detailed analysis for the deduction shown on line 16 of Schedule F.

He uses Form 4562 to explain his depreciation deduction and any section 179 deduction he takes. He follows the instructions for the form and lists the information called for in Parts I through IV. He also completes Part V on page 2 of the form to provide information on listed property used in his farming business. The three vehicles used in his business are listed property. The truck placed in service in 1980 was fully depreciated in 1988. No depreciation is allowed for 1990.

Mr. Brown bought his farm on January 8, 1978. Timber on the farm was immature and had no fair market value. He immediately divided the total purchase price of the farm among the land, house, barn, and fences (no other improvements were made on the farm). The fences were fully depreciated in 1987. The division was made on the basis of the respective fair market values of the items on the date the farm was bought. See the example under *Allocating the Basis* in Chapter 7. He entered the part of the purchase price that applied to the depreciable property in his depreciation record as its cost, giving him a basis for figuring his depreciation allowance.

He depreciates all his property placed in service before 1981 using the straight-line method. He depreciates most of his assets placed in service after 1980 using the regular ACRS method. However, for machine sheds #1 and #2, he chose the alternate ACRS method. He depreciates all his property placed in service in 1987 and 1988 using the alternate MACRS method.

One of his purchased dairy cows was killed by lightning in July 1990. Another purchased cow (#52) was sold on February 1, 1990. It was depreciated under MACRS, using a half-year convention. Therefore, he can claim half a year of depreciation for this cow in 1990.

Two dairy cows were also sold in 1990. Mr. Brown has other breeding and dairy cows that he raised. He did not claim depreciation on them because he deducted the cost of raising them and they have no basis for income tax purposes.

For part of 1990, he owned two family cars. One of them, which he bought for his wife, was not used for farm business. So the depreciation on it is not an allowable deduction. He determined that his other car was used 60% in his farm business and 40% for personal driving.

The MACRS–ACRS depreciation record consists of an itemized listing of all Mr. Brown's depreciable assets placed in service after 1980. They must be listed separately on the depreciation record in order to keep track of the basis and investment credit on each asset. The pickup truck purchased in 1988 is listed property that is 5–year recovery property.

He added three assets to the business in 1990. In January, he completed and placed in service a new beef cattle feeding facility. Since the new structure is designed specially to house, feed, and care for beef cattle, it is a single purpose livestock structure. The structure is 10–year property under MACRS. It is depreciated using the 150% declining balance method under MACRS. The total cost of the structure was $37,500 and includes the structure, site preparation, feeding system, and paved feeding area.

The new tractor, tractor #5, acquired in March by trading tractor #2 and paying $24,232 cash, has a cost basis of $24,714.37 ($24,232 + $482.37) and is 7–year property. (The adjusted basis of tractor #2 was $482.37 when it was traded, since Mr. Brown could not claim depreciation on it in the year he traded it.) In February, he made improvements to machine shed #1 for a total cost of $1,300. The improvements are depreciated as if they were a separate building included in the 20–year property class.

Since he elected to currently deduct certain preproductive expenses, he must depreciate the assets added in 1987 and 1988 under the ***alternate MACRS method.*** This is a straight-line method applied over the required class life of the property with a half-year convention.

Mr. Brown revoked the election in 1989. Therefore, he does not have to use the alternate MACRS method for assets added in 1990. However, he must continue to use the alternate MACRS method for the assets placed in service in 1987 and 1988. If he did not revoke the election, he would have to continue using the alternate MACRS method for assets placed in service after 1988.

Form 4562 is completed by referring to his depreciation records. He elects to take a section 179 deduction of $10,000 on tractor #5, which was placed in service during 1990. All property acquired in 1990 in each class is combined and entered in Part II, line 14. The abbreviation HY used in column e stands for the half-year convention. The 150 DB in column f stands for the 150% declining balance method under MACRS.

On line 19, Mr. Brown enters his depreciation deduction for listed property, $2,885.20. This is the total shown in column h, Part V, on page 2 of the form. He has two depreciable assets that are listed property for the purpose of completing Part V—the car used 60% for business and the pickup truck purchased in 1988. He completes Sections A and B of Part V to provide the information required for listed property. He does not complete Section C because he does not provide vehicles for his employees' use.

He has a practice of writing down the odometer readings on his vehicles at the end of each year and when he acquires and disposes of the vehicles. In addition, because he used his car for business, he writes down the number of business miles it is driven any day that it is used for business. He uses these records to answer the questions on lines 22a and 22b of Section A and lines 27 through 33 in Section B.

On line 16 of Part III, Mr. Brown enters $2,903.51, his MACRS depreciation deduction for assets acquired in 1987, 1988, and 1989. On line 18, he enters $1,640.68 for assets placed in service before 1981 and those depreciated under ACRS that are not listed property.

Mr. Brown totals the depreciation in Part IV of Form 4562 on line 20 and carries the total, $21,867, to line 16 of Schedule F.

He has no amortization, so he does not use Part VI of Form 4562.

Schedule SE (Form 1040) Self-Employment Tax

After figuring his net farm profit on page 1 of Schedule F, Mr. Brown figures his self-employment tax. To do this, he figures his net earnings from farm self-employment on Short Schedule SE (Section A), since he is not required to use Long Schedule SE (Section B). First he prints his name (as shown on his social security card) and his social security number at the top of Schedule SE.

Line Items. Mr. Brown figures his self-employment tax on the following lines.

Line 1. He enters his net farm profit, $11,684, on line 1 of Section A. He did not list on Schedule F any income, losses, or deductions that are not included in determining net earnings from farm self-employment (see the items listed in Chapter 15). Consequently, he did not have to adjust his net profit for any items to determine his self-employment net earnings from farming.

Line 3. If Mr. Brown were engaged in any other business in addition to farming, he would combine his net earnings from self-employment from all his trades or businesses on line 3 of this Schedule. However, since farming was his only business, he enters his net earnings from self-employment from farming (the amount shown on line 1) on line 3.

Line 4. He multiplies the amount on line 3 by .9235 and enters $10,790.17 on line 4.

Lines 7 and 8. Because Mr. Brown received no wages or unreported tips subject to social security tax in 1990, he shows $51,300 (maximum net earnings from self-employment) on line 7. Since his total net earnings are less than the maximum net earnings from self-employment, he enters $10,790.17 on line 8.

Line 10. Mr. Brown enters his self-employment tax of $1,651 on line 10 of Short Schedule SE, and on line 48 of Form 1040.

Form 4684—Casualties

Mr. Brown's only casualty was a dairy cow that was killed by lightning in July. He shows the loss from the casualty on page 2 of Form 4684. Only page 2 is shown, since page 1 is for nonbusiness casualties.

He prints his name and identifying number and his wife's name at the top of page 2.

Mr. Brown shows the kind of property, "Dairy cow #42," its location, and the date of purchase on line 1. He enters his basis in the cow, $252, on line 2 and the $152 insurance payment he received for the cow on line 3. Since line 2 is more than line 3, he skips line 4. On lines 5 and 6, he enters the fair market value before, $500, and after, -0-, the casualty, and he shows the difference, $500, on line 7. Since the cow was business property that was totally destroyed, Mr. Brown enters the amount from line 2 on line 8, subtracts line 3 from line 8, and enters $100 on lines 9 and 10. On line 16, he identifies the casualty and enters $100 on lines 16(b)(i), 17(b)(i), 19, and 20a, and on line 14, column g, Part II, of Form 4797.

Form 4797—Sales of Business Property

After completing Schedule F and Form 4684, Mr. Brown fills in Form 4797 to report the sale and exchange of business property. See the table in Chapter 11 for examples of items reported on Form 4797.

He prints his name and identifying number and his wife's name at the top of Form 4797.

Before he can complete Parts I and II, Mr. Brown must complete Part III to report the sale of certain depreciable property.

He sold a truck on July 7, 1990, and a mower on February 14, 1990. He also sold one purchased dairy cow, #41, on October 28, 1990. Since the gain on these items was gain from dispositions of depreciable personal property, as explained in Chapter 11, he had to determine the part of his gain that was ordinary income.

Mr. Brown enters the description of each of these items on lines 19(A) through 19(C) of Form 4797 and relates those lines to the corresponding columns. He completes lines 20 through 25(b) for each disposition of property. As shown on line 24, column (A), his total gain on the sale of the truck is $700. His gain on the sale of the mower on line 24, column (B), is $70. All the gain on both items is from depreciation after 1961 and is entered on line 25(b).

Gain on the sale of livestock must be reported as ordinary income to the extent it is from depreciation after 1969. As shown on line 24, column (C), the total gain on the sale of cow #41 is $327. All of that amount is from depreciation after 1969 and is reported on line 25(b).

On line 30 of the *Summary of Part III Gains*, he enters $1,097, the total of property columns (A) through (C), line 24. On line 31, he enters $1,097, the total of property columns (A) through (C), line 25(b). This amount is the gain that is ordinary income. He also enters that same amount on line 13, Part II. He subtracts the amount on line 31 from that on line 30 and enters -0- on line 32.

Now Mr. Brown goes to Part I. During 1990, he sold at a gain 10 cows he raised and used for dairy purposes. His selling expense was $101 for these cows. All of these cows had been held 2 years or more. He enters the amount of gain from the sale of these cows on line 2. He also enters on line 2 the gain from the sale of a raised dairy heifer and the loss from the sale of purchased dairy cow #52. He also enters this loss on line 6, column g.

He totals the gains on line 2 and enters this amount on line 6, column h. He combines the loss on line 6, column g, with the gain on line 6, column h, and enters the result on line 7. Since he does not have any nonrecaptured net section 1231 losses from prior years, he does not fill in lines 8 and 9. Following the instructions for line 7, he enters that same amount as a long-term capital gain on Schedule D.

Mr. Brown enters the $250 gain from the sale of a raised dairy calf that is less than 2 years old on line 10. He previously had entered the $1,097 gain from line 31, Part III, on line 13 and the $100 loss from Form 4684 on line 14, column g. He adds lines 10 through 16 for columns g and h and enters the results on line 17. Then he combines these amounts and enters a net gain of $1,247 on line 18. He carries the gain from line 18 to line 18(b)(2) and shows it as ordinary income on line 15 of Form 1040.

Schedule D (Form 1040) Capital Gains and Losses

After he completed Form 4797, Mr. Brown fills in Schedule D to report gains and losses on capital assets and to reconcile his Form 1099–B with amounts shown on his Schedule D. He prints his name, his wife's name, and his social security number at the top of Schedule D.

Entries. He enters the information called for in the appropriate columns.

Line 1. He shows on line 1 the amount from the Form 1099–B he received from his stockbroker, reporting his sales of shares of H. T. Corporation stock.

Lines 2a and 2c. Mr. Brown reports as a short-term loss on line 2a his $50 loss on the sale of H. T. Corporation stock held one year or less. He includes the gross sale price of the stock in column d on both lines 2a and 2c.

Line 2d. He shows as a short-term capital loss on line 2d an amount he had loaned to a friend. During 1990 this $50 loan became uncollectible.

Lines 7 and 8. Mr. Brown completes Part I of Schedule D by filling in lines 7 and 8.

Lines 9a and 9c. He enters on line 9a his $745 long-term gain on the sale of H. T. Corporation stock held more than one year and also enters the gross sale price on line 9c.

Line 14. Mr. Brown previously entered on line 14 the gain from line 7 of Form 4797.

Lines 16 and 17. He completes Part II of Schedule D by filling in lines 16 and 17 according to the instructions given on those lines.

Line 18—Net gain. In Part III, Mr. Brown combines lines 8 and 17 and enters his net gain on line 18. He also enters this amount on Form 1040, line 13.

Mr. Brown does not have a capital loss carryover or an installment sale this year, so he does not complete Part IV or Part V of Schedule D.

Mr. Brown does not complete Part VI of Schedule D because he received no bartering income.

Form 1040, Page 1

Mr. Brown is filing a joint return with his wife. He uses the return he received from the IRS. He checks the proper box to indicate he is married and filing a joint return.

Mr. and Mrs. Brown choose to designate $2 (for each of them) of their tax to be applied to the Presidential Election Campaign Fund. He, therefore, checks both "Yes" boxes.

He checks boxes 6a and 6b to claim the regu $2,050 exemptions for himself and his wife, and enters the number of boxes checked in the far right-hand entry space. The Browns' three children live with them. He lists their names, checks the box whether they are under age 2, li their social security numbers where applicable, lists their relationship, enters the number of months they lived in his house in 1990, and clai these three exemptions in the appropriate right-d entry space for line 6c. He has no other endents. He enters a total of five exemptions he far right-hand box on line 6e.

e Items. Mr. Brown fills in all applicable ome items on page 1 of Form 1040,

ine 7. Mrs. Brown worked part time as a stitute teacher for the county school system ing 1990. She also works for Mr. Brown on the m. Mr. Brown enters her total wages, $3,095 ,895 from the school system and $1,200 from farm), on line 7 of Form 1040, as shown on Forms W–2 that each employer gave her.

Lines 8a and 9. Mr. Brown did not actually ceive cash payment for the interest he listed on e 8a. It was credited to his account so that he uld have withdrawn it from his account in 1990 d he wanted to. He constructively received it d correctly included it in his income for 1990. enters the $220 in dividends he received from e H. T. Corporation on line 9.

Patronage dividends from farmers' cooperatives ere received on the basis of business done with ese cooperatives. He does not list these dividends here, but properly included them on line 5a nd line 5b, Part I of Schedule F.

Since Mr. Brown did not receive more than 400 in interest or $400 in dividends and had no reign bank accounts or any interest in a foreign ust, he is not required to complete Schedule B Form 1040).

Had he been engaged in a business other than rming, he would have included on line 12 his come or loss from that business.

Line 13. The amount shown on line 13, 6,029, is the net gain from the sale or exchange capital assets listed on Schedule D (Form 1040).

Line 15. The amount shown on line 15, 1,247, is the net gain from Form 4797.

Line 19. On line 19, Mr. Brown enters his net rm profit, $11,684, from Schedule F (Form 1040).

If either Mr. or Mrs. Brown had received income from any other source not included on lines 7 through 21, that income would be listed on line 22.

Line 23. Mr. Brown adds the amounts on lines 7 through 22 and enters the total, $22,650, on line 23.

Lines 31 and 32. Since Mr. Brown had no adjustments to income, he carries the amount from line 23 and enters the result, "adjusted gross income," on line 31 and on line 32 of page 2.

Schedule A (Form 1040) Itemized Deductions

Mr. Brown keeps a record of his deductible expenses on Schedule A (Form 1040). This year he determined that the deductible amount of these expenses was $5,764.

Medical and dental expenses. Mr. and Mrs. Brown's medical expenses consisted of $214 for prescription medicines and drugs, $1,453 for doctors and dentists, $42 for transportation, and $237 for eyeglasses.

He enters the $1,946 spent for medicines and drugs, doctors, dentists, and other medical expenses that are subject to the 7.5% limitation. He enters his total medical expenses on line 1. On line 2, he enters his adjusted gross income. On line 3, he enters 7.5% of adjusted gross income, $1,699. He subtracts the amount on line 3 from the amount on line 1 and enters the difference, $247, on line 4. This is Mr. Brown's medical expense deduction.

Taxes. Mr. Brown enters the state income tax he paid in 1990 on his 1989 income, $1,780, on line 5. The 40% of the auto license fee prorated to personal use is not deductible. He prorated the taxes paid on the farm between the property used in farming and his personal residence. He made the allocation on the basis of assessed valuations. Only the tax allocated to the dwelling, $962, is listed on line 6 of Schedule A (Form 1040). Total taxes on line 8 are $2,742.

Interest. Mr. Brown paid interest on a mortgage on his farm, purchased before August 1986. He prorated the interest among the residence and the farmland and buildings. The part for the mortgage on the dwelling occupied by him and his family, $2,200, is entered on line 9a. He claimed the part for the farmland and buildings on Schedule F. Total interest expense on line 13 is $2,200.

Contributions. Mr. Brown enters his total cash contributions, $575, on line 14. He enters the entire amount of the contributions paid to organizations of the type specified in the instructions received with his return forms, because the total was less than the limitation. Only the amounts paid in 1990 were included. Since there were no other contributions for 1990, he enters this amount on line 17.

Miscellaneous deductions. Mr. Brown enters on line 21 the $42 rent paid on a safe deposit box used to store his income-producing securities. He also enters $42 on line 22, his total miscellaneous deductions. He enters -0- on line 25, since the total miscellaneous deductions do not exceed the 2% limitation on line 24.

Total itemized deductions. Mr. Brown totals the amounts on lines 4, 8, 13, and 17. On line 27, he shows a total of $5,764. He enters $5,764 on line 34 of Form 1040.

Form 1040, Page 2

Mr. Brown fills in the following lines on page 2 of Form 1040.

Line 37. Mr. Brown subtracts the $5,764 on line 34 from the $22,650 on line 32 and enters the result, $16,886, on line 35. He enters $10,250 (5 × $2,050) on line 36 and subtracts this amount from the amount on line 35 to get taxable income on line 37.

Lines 38 and 40. To determine their tax, he uses the Tax Table in the instructions they received with their return forms. Since the amount on line 37 is $6,636, he looks for the income bracket that includes this amount. He finds the bracket that is for incomes of at least $6,600, but less than $6,650, and finds that the tax for married taxpayers filing joint returns is $994. He enters this amount on line 38 and checks the box for Tax Table. Since line 39 does not apply to him, he makes no entry on this line. He enters $994 on line 40.

Had Mr. and Mrs. Brown been unable to use the Tax Table because their taxable income was more than $50,000, they would have figured their tax by using Tax Rate Schedule Y–1.

Line 47. Mr. and Mrs. Brown have none of the credits listed on lines 41 through 45, so Mr. Brown enters -0- on line 46, subtracts it from line 40, and enters $994 on line 47.

Line 48. On line 48, Mr. Brown enters the $1,651 self-employment tax that he figured on Schedule SE.

Line 54. On line 54, he enters $2,645, which is the total tax for 1990.

Line 55. On line 55, Mr. Brown enters the income tax withheld from Mrs. Brown's wages, $227, as shown on the Form W–2 she received. He attaches Copy B of her Form W–2 to the return.

He did not make estimated tax payments, since two-thirds of his gross income for 1989 was from farming. He was sure that at least two-thirds of his gross income for 1990 would be from farming, and he would file his return, Form 1040, not later than March 1, 1991. Farmers who meet these conditions do not have to make estimated tax payments. Therefore, he makes no entry on line 56.

The Browns are not entitled to claim the earned income credit on line 57, since their adjusted gross income on line 31 and their earned income are more than $20,264.

Line 60. On line 60, Mr. Brown enters his credit for gasoline tax. He attaches to his return Form 4136 (not illustrated) showing how he figured the credit.

Line 66. He adds the amounts on lines 55 and 60 and enters the total on line 62. He subtracts that figure from the amount on line 54. The balance, $2,068, is entered on line 66. This is the amount Mr. and Mrs. Brown must pay when they file their return.

Completing the return. They sign their names, enter the date signed, and enter their occupations. (If the Browns had not prepared their own tax return, the preparer would also sign the return and provide the information requested at the bottom of the page.) Mr. Brown transfers the address label from the cover of the instructions to the return after verifying the accuracy of the label, then writes a check payable to the Internal Revenue Service for the full amount on line 66 of Form 1040. On the check, he writes his social security number, their telephone number, and "1990 Form 1040."

After making a copy of their return and the supporting schedules for his records, Mr. Brown mails his original Form 1040, Schedules A, D, F, and SE, and Forms 4136, 4684, 4797, and 4562 assembled in that order (see "Attachment Sequence Number" at the top of each schedule or form) along with his check to the Internal Revenue Service Center. He uses the envelope he received with his return. If the Browns were including any of their own supplementary schedules or statements with their return, they would attach them after all of the official forms and schedules, assembled in the same order as the forms and schedules they relate to.

For Illustrated Exhibits, Forms, and Schedules, see next page.

Cash Farm Receipts

LINE	Date 1990 JAN	Item	No. or Head	Quantity	Total Amount	Schedule F Part I						
						Livestock Purchased for Resale			Raised Livestock			Poultry
						Steers			Calves	Steers		
Column No.			1	2	3	4	5	6	7	8	9	10
1	4	Bob Calves - Farm Livestock Sales	2		102				102			
2	12	Hay - Horseraisers, Inc.			1,450							
3	15	Cull Cow (Raised) - FLS	1		435							
4	18	Corn - Co. Feed			2,000							
5	22	Milk - Dairy County Coop		93,729	5,110 90							
6	29	Patronage Refund - Central Coop			16 25							
7	29	Gas Tax Credit Claimed On 1989 Return			192							
8												
9												
10												
11												
12												
35												
36												
		TOTALS		661,530	129,775	12,960			1,000	1,503		

Cash Farm Expenses

LINE	Date 1990 JAN	Item	No. or Head	Quantity	Total Amount	Schedule F Part I		Schedule F Part II Items					
						Livestock Purchased for Resale		Hired Labor	Repairs		Interest Paid	Feed Purchased	Seeds Sprays and Crop Expense
						Steers			Buildings	Machinery			
Column No.			1	2	3	4	5	6	7	8	9	10	11
1	4	Dairy Feed - Co. Feed			1,822							1,822	
2	4	Beef Feed - Co. Feed			456 80							456 80	
3	4	Gasoline - Central Coop			606 96								
4	5	Wages - J. Jones			240			240					
5	12	Vet & Medicine - Dr. Sharp			63 75								
6	15	Trucking - C. Dealer			25								
7	15	Commission - FLS			12 50								
8	19	Breeding Fees - Top Breeders			59								
9	22	Milk Hauling - DCC			192 51								
10	22	Dues - DCC			41 73								
11	22	Advertising - DCC			20 37								
12													
35	29	Electricity - Rural Electric			705 39								
36	29	County Taxes - C. Clerk			1,672 68								
		TOTALS			153,999	9,570		16,416	522	9,902	9,218	18,162	9,833

Cash Farm Receipts

Schedule F Part I

Field Crops		Milk	Wheat	Vegetables	CCC Loan		Patronage Dividends and Refunds	Ag'l Program Payments	Other	Special Items	NON-OPERATING INCOME			
											CAPITAL ASSETS SOLD (Schedule D Items)			
											Purchased or Raised Dairy and Breeding Stock		Buildings and Improvements	Machinery and Equipment
Hay	Corn													
11	12	13	14	15	16	17	18	19	20	21	22	23	24	25
1,450														
											935			
	2,000													
		5,110 80												
							16 25							
										192				
8,250	7,050	80,121	7,892	783	665		33	438	567	1,258	6,485			770

Cash Farm Expenses

Schedule F Part II Items

	Fertilizer and Lime	Machine Hire	Supplies	Livestock Expense	Gas Oil and Fuel	Taxes Including	Insurance Nonfarm	Utilities Share	Trucking & Milk Marketing Expenses	Conservation Expenses	Other	Special Items	NON-OPERATING EXPENDITURES			
													CAPITAL ASSETS BOUGHT (Schedule D Items)			
													Purchased Dairy and Breeding Stock		Buildings and Improvements	Machinery and Equipment
	12	13	14	15	16	17	18	19	20	21	22	23	24	25	26	27
1																
2																
3					606 96											
4																
5				63 75												
6									25							
7											12 50					
8				54												
9									192 51							
10									41 73							
11									20 87							
12																
35								705 39								
36						1,672 18										
	6,544	1,581	2,807	3,217	5,233	4,153	1,830	4,735	3,879	1,090	3,285				38,890	29,232

DEPRECIATION RECORD

Description	Date Acquired	Cost			New or Used	Investment Credit			Additional First Year Depreciation	Salvage Value	Depreciation Information				19 90		19_
		Undepreciated Value of Trade-In	Paid To Boot	Total Cost		Amount	Year Claimed	Year Used			Balance for Regular Depreciation	Life	Method	Depreciation Prior Years	Depreciable Balance Beginning of Year	Depreciation This Year	Depreciable Balance Beginning of Year
Barn	1-8-78			6,400	U					None	6,400	25	SL	3,072	3,328	256	3,072
Silo	1-3-80			12,000	N	1,200	1980	1980		None	12,000	15	SL	8,000	4,000	800	3,200
Truck	6-21-80			4,390	U	439	1980	1980		None	4,390	8	SL	4,390	-0-	-0-	Sold 7-
Mower	9-17-80			1,200	N	80	1980	1980		None	1,200	6	SL	1,200	-0-	-0-	Sold 3-

MACRS-ACRS Depreciation Record

Description	Date of Purchase	Cost			Section 179 Expense Deduction	Investment Credit Basis Adjustment	Unrecovered Cost	ACRS		New or Used	Investment Credit			19 90			19 9	
		Unrecovered Cost of Trade-In	Boot Paid	Total Cost				Class[1]	Method[2]		Amount	Year Claimed	Year Used	%	Unrecovered Cost Beginning of Year	Cost Recovered This Year	%	Unrecovered Cost Beginning of Year
Machine Shed #1	1-6-84			9,000			9,000	15	15	N				6.667	2,399 92	266 68	6.667	2,133
Dairy Cow #41	2-21-85			900			900	5	A	U	90	1985	1985		-0-	-0-	Sold	10-28-9
Machine Shed #2	1-2-86			6,000			6,000	19	19	N				5.3	4,796	318	5.3	4,478
Tractor #2	1-8-86			7,297	5,000		2,297	5	A	N				21	482 37	-0-	Traded	3-7-
Dairy Cow #42	6-21-86			600			600	5	A	U				21	126	-0-	Killed	by ligh
Dairy Cow #52	7-15-87			900			900	7	SL/HY	U				14.29	578 52	69 26	Sold	2-1-9
Dairy Cow #54	9-7-87			1,200			1,200	7	SL/HY	U				14.29	771 36	171 36	14.29	600
Car	1-6-88			7,410			7,410	5	SL/HY	N				20	5,187	1,481	20	3,706
Dairy Cow #60	2-3-88			1,400			1,400	7	SL/HY	U				14.29	1,099 92	200 06	14.28	899
Plow	4-5-88			4,821			4,821	10	SL/HY	N				10	4,097 85	482 10	10	3,615
Pickup Truck	5-22-88			7,076			7,076	5	SL/HY	U				20	4,953 20	1,415 20	20	3,538
Dairy Cow #61	9-1-88			1,400			1,400	7	SL/HY	U				14.29	1,099 92	200 06	14.28	899
Tractor #4	10-1-88	3,800	9,683	13,483	5,000		8,483	10	SL/HY					10	7,210 55	848 30	10	6,362
Milk Tank	1-3-89			11,500	10,000		1,500	7	150 DB/HY					19.13	1,339 35	286 95	15.03	1,052
Manure Spreader	5-1-89			3,400			3,400	7	150 DB/HY					19.13	3,035 86	650 42	15.03	2,385
Beef Cattle Feeding Facility	1-8-90			37,500			37,500	10	150 DB/HY					7.5	37,500	2,812 50	13.88	34,687
Machine Shed #1 Improvement	2-19-90			1,300			1,300	20	150 DB/HY					3.75	1,300	48 75	7.219	1,251
Tractor #5	3-7-90	482 37	29,232	29,714 37	10,000		19,714 37	7	150 DB/HY					10.71	19,714 37	1,575 91	19.13	18,138

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[1] **Before 1987:** Enter 3, 5, 10, 15, 18, or 19.
After 1986: Enter 3, 5, 7, 10, 15, 20, 27.5, or 31.5.

[2] **Before 1987:** For 3-year class property, enter A (for Accelerated) or 3, 5, or 12 for straight line.
For 5-year class property, enter A (for Accelerated) or 5, 12, or 25 for straight line.
For 10-year class property, enter A (for Accelerated) or 10, 25, or 35 for straight line.
For 15-year class property, enter A (for Accelerated) or 15, 35, or 45 for straight line.
For 18-year class property, enter A (for Accelerated) or 18, 35, or 45 for straight line.
For 19-year class property, enter A (for Accelerated) or 19, 35, or 45 for straight line.
After 1986: For method of figuring depreciation, enter DDB, 150% DB, or SL. For half-year, mid-month, or mid-quarter conventions, enter HY, MM, MQ, respectively.

[1] Before 1981, in figuring depreciation on personal property (other than livestock), you could choose to reduce salvage value by any amount up to 10% of your basis in the property. Because the estimated salvage value on the truck, the mower, and the farm equipment was less than 10% of basis, Mr. Brown chose to ignore salvage value in figuring depreciation on these assets. You do not subtract salvage value for recovery property depreciated under ACRS. See Chapter 8.

SCHEDULE F
(Form 1040)

Department of the Treasury
Internal Revenue Service

Farm Income and Expenses

▶ Attach to Form 1040, Form 1041, or Form 1065.

▶ See Instructions for Schedule F (Form 1040).

OMB No. 1545-0074

1990

Attachment Sequence No. 14

Name of proprietor: Walter A. Brown

Social security number (SSN): 579 : 00 : 6685

A Principal product. (Describe in one or two words your principal crop or activity for the current tax year.) Milk

B Enter principal agricultural activity code (from page 2) ▶ 2 4 0

C Accounting method: ☑ Cash ☐ Accrual

D Employer ID number (Not SSN): 1 0 9 3 6 7 9 7 4

E Did you make an election in a prior year to include Commodity Credit Corporation loan proceeds as income in that year? ☑ Yes ☐ No

F Did you "materially participate" in the operation of this business during 1990? (If "No," see Instructions for limitations on losses.) ☑ Yes ☐ No

G Do you elect, or did you previously elect, to currently deduct certain preproductive period expenses? (See Instructions.) ☑ Does not apply ☐ Yes ☐ No

Part I Farm Income—Cash Method—Complete Parts I and II (Accrual method taxpayers complete Parts II and III, and line 11 of Part I.)

Do not include sales of livestock held for draft, breeding, sport, or dairy purposes; report these sales on Form 4797.

1 Sales of livestock and other items you bought for resale	1	12,960		
2 Cost or other basis of livestock and other items you bought for resale	2	3,180		
3 Subtract line 2 from line 1			3	9,780
4 Sales of livestock, produce, grains, and other products you raised			4	106,599
5a Total cooperative distributions (Form(s) 1099-PATR)	5a	33	5b Taxable amount 5b	33
6a Agricultural program payments (see Instructions)	6a	438	6b Taxable amount 6b	438
7 Commodity Credit Corporation (CCC) loans:				
a CCC loans reported under election (see Instructions)			7a	665
b CCC loans forfeited or repaid with certificates	7b		7c Taxable amount 7c	
8 Crop insurance proceeds and certain disaster payments (see Instructions):				
a Amount received in 1990	8a		8b Taxable amount 8b	
c If election to defer to 1991 is attached, check here ▶ ☐			8d Amount deferred from 1989 8d	
9 Custom hire (machine work) income			9	1,258
10 Other income, including Federal and state gasoline or fuel tax credit or refund (see Instructions)			10	567
11 Add amounts in the right column for lines 3 through 10. If accrual method taxpayer, enter the amount from page 2, line 51. This is your **gross income** ▶			11	119,340

Part II Farm Expenses—Cash and Accrual Method (Do not include personal or living expenses such as taxes, insurance, repairs, etc., on your home.)

12 Breeding fees	12	746	24 Labor hired (less jobs credit)	24	16,416
13 Chemicals	13	2,701	25 Pension and profit-sharing plans	25	
14 Conservation expenses (you must attach **Form 8645**)	14	1,040	26 Rent or lease (see Instructions):		
			a Vehicles, machinery, and equip.	26a	
15 Custom hire (machine work)	15	1,581	b Other (land, animals, etc.)	26b	2,400
16 Depreciation and section 179 expense deduction not claimed elsewhere (see Instructions)	16	21,861	27 Repairs and maintenance	27	5,424
			28 Seeds and plants purchased	28	2,132
			29 Storage and warehousing	29	
17 Employee benefit programs other than on line 25	17		30 Supplies purchased	30	2,807
			31 Taxes	31	3,231
18 Feed purchased	18	18,226	32 Utilities	32	3,997
19 Fertilizers and lime	19	6,544	33 Veterinary fees and medicine	33	2,471
20 Freight and trucking	20	3,072	34 Other expenses (specify):		
21 Gasoline, fuel, and oil	21	5,233	a Milk Assessment	34a	807
22 Insurance (other than health)	22	1,580	b Commissions, Dues, Fees	34b	348
23 Interest:			c Financial Records	34c	287
a Mortgage (paid to banks, etc.)	23a	3,175	d Travel	34d	534
b Other	23b	1,043	e	34e	

35 Add amounts on lines 12 through 34e. These are your **total expenses** ▶	35	107,656
36 **Net farm profit or (loss).** Subtract line 35 from line 11. If a profit, enter on Form 1040, line 19, and on Schedule SE, line 1. If a loss, you MUST go on to line 37. (Fiduciaries and partnerships, see Instructions.)	36	11,684

37 If you have a loss, you MUST check the box that describes your investment in this activity (see Instructions).
37a ☐ All investment is at risk.
37b ☐ Some investment is not at risk.

If you checked 37a, enter the loss on Form 1040, line 19, and Schedule SE, line 1
If you checked 37b, you MUST attach **Form 6198**.

For Paperwork Reduction Act Notice, see Form 1040 Instructions.

Schedule F (Form 1040) 1990

Proof as of 10/16/90

Form **4562**

Department of the Treasury
Internal Revenue Service

Depreciation and Amortization
(Including Information on Listed Property)

▶ **See separate instructions.** ▶ **Attach this form to your return.**

OMB No. 1545-0172
1990
Attachment Sequence No. **67**

Name(s) shown on return: Walter A. & Jane W. Brown

Identifying number: 579-00-6685

Business or activity to which this form relates:

Part I **Election To Expense Certain Tangible Property (Section 179)** (**Note:** *If you have any "Listed Property," also complete Part V.)*

1 Maximum dollar limitation (see instructions)	1	$10,000
2 Total cost of section 179 property placed in service during the tax year (see instructions)	2	63,032
3 Threshold cost of section 179 property before reduction in limitation	3	$200,000
4 Reduction in limitation—Subtract line 3 from line 2, but do not enter less than -0-	4	-0-
5 Dollar limitation for tax year—Subtract line 4 from line 1, but do not enter less than -0-	5	10,000

	(a) Description of property	(b) Cost	(c) Elected cost
6	7-year tractor	24, 232	10,000
7 Listed property—Enter amount from line 26		7	

8 Total elected cost of section 179 property—Add amounts in column (c), lines 6 and 7	8	10,000
9 Tentative deduction—Enter the lesser of line 5 or line 8	9	10,000
10 Carryover of disallowed deduction from 1989 (see instructions)	10	–
11 Taxable income limitation—Enter the lesser of taxable income or line 5 (see instructions)	11	10,000
12 Section 179 expense deduction—Add lines 9 and 10, but do not enter more than line 11	12	10,000
13 Carryover of disallowed deduction to 1991—Add lines 9 and 10, less line 12 ▶	13	

Proof as of 10/16/90

Note: *Do not use Part II or Part III below for automobiles, certain other vehicles, cellular telephones, computers, or property used for entertainment, recreation, or amusement (listed property). Instead, use Part V for listed property.*

Part II **MACRS Depreciation For Assets Placed in Service ONLY During Your 1990 Tax Year (Do Not Include Listed Property)**

(a) Classification of property	(b) Mo. and yr. placed in service	(c) Basis for depreciation (Business use only—see instructions)	(d) Recovery period	(e) Convention	(f) Method	(g) Depreciation deduction
14 General Depreciation System (GDS) (see instructions):						
a 3-year property	▨					
b 5-year property	▨					
c 7-year property	▨	14,714	7	HY	150 DB	1,575.91
d 10-year property	▨	37,500	10	HY	150 DB	2,812.50
e 15-year property	▨					
f 20-year property	▨	1,300	20	HY	150 DB	48.75
g Residential rental property			27.5 yrs.	MM	S/L	
			27.5 yrs.	MM	S/L	
h Nonresidential real property			31.5 yrs.	MM	S/L	
			31.5 yrs.	MM	S/L	
15 Alternative Depreciation System (ADS) (see instructions):						
a Class life	▨				S/L	
b 12-year	▨		12 yrs.		S/L	
c 40-year			40 yrs.	MM	S/L	

Part III **Other Depreciation (Do Not Include Listed Property)**

16 GDS and ADS deductions for assets placed in service in tax years beginning before 1990 (see instructions)	16	2,903.51
17 Property subject to section 168(f)(1) election (see instructions)	17	
18 ACRS and other depreciation (see instructions)	18	1,640.68

Part IV **Summary**

19 Listed property—Enter amount from line 25	19	2,885.20
20 Total—Add deductions on line 12, lines 14 and 15 in column (g), and lines 16 through 19. Enter here and on the appropriate lines of your return. (Partnerships and S corporations—see instructions)	20	21,866.55
21 For assets shown above and placed in service during the current year, enter the portion of the basis attributable to section 263A costs (see instructions)	21	

For Paperwork Reduction Act Notice, see page 1 of the separate instructions.

Form **4562** (199

Form 4562 (1990)

Part V Listed Property.—Automobiles, Certain Other Vehicles, Cellular Telephones, Computers, and Property Used for Entertainment, Recreation, or Amusement

If you are using the standard mileage rate or deducting vehicle lease expense, complete columns (a) through (c) of Section A, all of Section B, and Section C if applicable.

Section A.—Depreciation (Caution: *See instructions for limitations for automobiles.*)

22a Do you have evidence to support the business use claimed? ☑ Yes ☐ No 22b If "Yes," is the evidence written? ☑ Yes ☐ No

(a) Type of property (list vehicles first)	(b) Date placed in service	(c) Business use percentage	(d) Cost or other basis	(e) Basis for depreciation (business use only)	(f) Recovery period	(g) Method/ Convention	(h) Depreciation deduction	(i) Elected section 179 cost
23 *Property used more than 50% in a trade or business:*								
Car 88 USA	1-6-88	60 %	12,350	7,410	5	S/L HY	1,470	
Truck 88 PIC	5-22-88	100 %	7,076	7,076	5	S/L HY	1,415.20	
		%						
24 *Property used 50% or less in a trade or business:*								▨
		%				S/L -		▨
		%				S/L -		▨
		%				S/L -		▨

25 Add amounts in column (h). Enter the total here and on line 19, page 1 . . . . . 25 2,885.20

26 Add amounts in column (i). Enter the total here and on line 7, page 1 26

Proof as of 10/16/90

Section B.—Information Regarding Use of Vehicles—*If you deduct expenses for vehicles:*

- *Always complete this section for vehicles used by a sole proprietor, partner, or other "more than 5% owner," or related person.*
- *If you provided vehicles to your employees, first answer the questions in Section C to see if you meet an exception to completing this section for those vehicles.*

	(a) Vehicle 1		(b) Vehicle 2		(c) Vehicle 3		(d) Vehicle 4		(e) Vehicle 5		(f) Vehicle 6	
27 Total business miles driven during the year (DO NOT include commuting miles)	6,870		11,350									
28 Total commuting miles driven during the year	-0-		-0-									
29 Total other personal (noncommuting) miles driven	3,580		-0-									
30 Total miles driven during the year—Add lines 27 through 29	10,458		11,350									
	Yes	No	Yes	No	Yes	No	Yes	No	Yes	No	Yes	No
31 Was the vehicle available for personal use during off-duty hours?	✓		✓									
32 Was the vehicle used primarily by a more than 5% owner or related person?	✓		✓									
33 Is another vehicle available for personal use?	✓		✓									

Section C.—Questions for Employers Who Provide Vehicles for Use by Their Employees

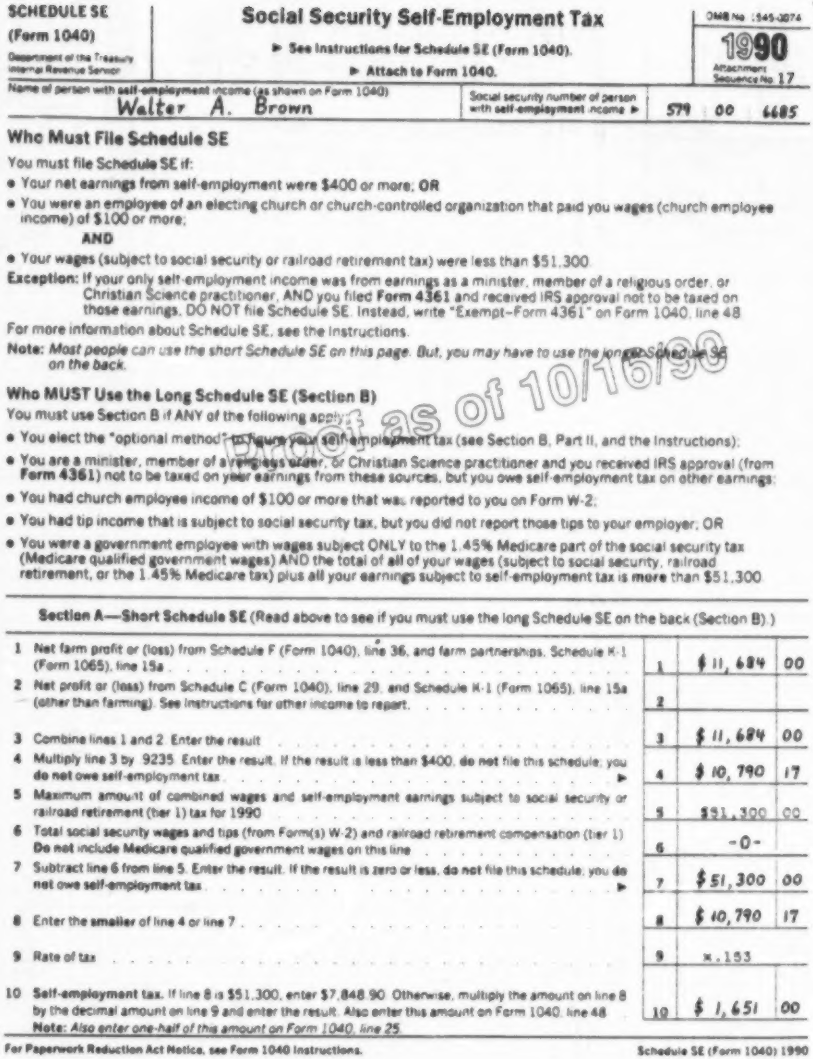
(Answer these questions to determine if you meet an exception to completing Section B. **Note:** *Section B must always be completed for vehicles used by sole proprietors, partners, or other more than 5% owners or related persons.)*

	Yes	No
34 Do you maintain a written policy statement that prohibits all personal use of vehicles, including commuting, by your employees?		
35 Do you maintain a written policy statement that prohibits personal use of vehicles, except commuting, by your employees? (See instructions for vehicles used by corporate officers, directors, or 1% or more owners.)		
36 Do you treat all use of vehicles by employees as personal use?		
37 Do you provide more than five vehicles to your employees and retain the information received from your employees concerning the use of the vehicles?		
38 Do you meet the requirements concerning qualified automobile demonstration use (see instructions)?		

Note: *If your answer to 34, 35, 36, 37, or 38 is "Yes," you need not complete Section B for the covered vehicles.*

Part VI Amortization

(a) Description of costs	(b) Date amortization begins	(c) Amortizable amount	(d) Code section	(e) Amortization period or percentage	(f) Amortization for this year
39 Amortization of costs that begins during your 1990 tax year:			▨	▨	▨
40 Amortization of costs that began before 1990				40	
41 Total. Enter here and on "Other Deductions" or "Other Expenses" line of your return				41	



SCHEDULE SE
(Form 1040)
Department of the Treasury
Internal Revenue Service

Social Security Self-Employment Tax

▶ See Instructions for Schedule SE (Form 1040).
▶ Attach to Form 1040.

OMB No. 1545-0074
1990
Attachment Sequence No. 17

Name of person with self-employment income (as shown on Form 1040): Walter A. Brown
Social security number of person with self-employment income ▶ 579 00 6685

Who Must File Schedule SE

You must file Schedule SE if:

- Your net earnings from self-employment were $400 or more; **OR**
- You were an employee of an electing church or church-controlled organization that paid you wages (church employee income) of $100 or more;

AND

- Your wages (subject to social security or railroad retirement tax) were less than $51,300.

Exception: If your only self-employment income was from earnings as a minister, member of a religious order, or Christian Science practitioner, AND you filed **Form 4361** and received IRS approval not to be taxed on those earnings, DO NOT file Schedule SE. Instead, write "Exempt–Form 4361" on Form 1040, line 48.

For more information about Schedule SE, see the Instructions.

Note: *Most people can use the short Schedule SE on this page. But, you may have to use the longer Schedule SE on the back.*

Who MUST Use the Long Schedule SE (Section B)

You must use Section B if ANY of the following apply:

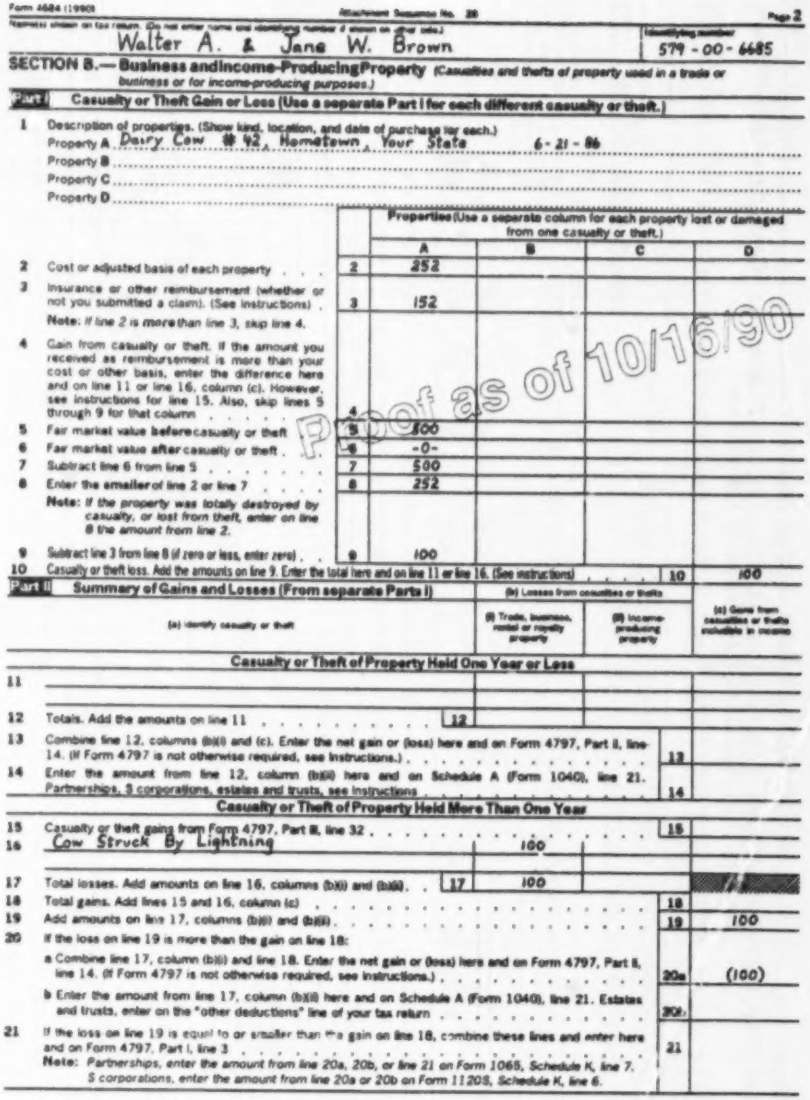
- You elect the "optional method" to figure your self-employment tax (see Section B, Part II, and the Instructions);
- You are a minister, member of a religious order, or Christian Science practitioner and you received IRS approval (from **Form 4361**) not to be taxed on your earnings from these sources, but you owe self-employment tax on other earnings;
- You had church employee income of $100 or more that was reported to you on Form W-2;
- You had tip income that is subject to social security tax, but you did not report those tips to your employer; OR
- You were a government employee with wages subject ONLY to the 1.45% Medicare part of the social security tax (Medicare qualified government wages) AND the total of all of your wages (subject to social security, railroad retirement, or the 1.45% Medicare tax) plus all your earnings subject to self-employment tax is more than $51,300.

Proof as of 10/16/90

Section A—Short Schedule SE (Read above to see if you must use the long Schedule SE on the back (Section B).)

1	Net farm profit or (loss) from Schedule F (Form 1040), line 36, and farm partnerships, Schedule K-1 (Form 1065), line 15a	1	$ 11, 684	00
2	Net profit or (loss) from Schedule C (Form 1040), line 29, and Schedule K-1 (Form 1065), line 15a (other than farming). See Instructions for other income to report.	2		
3	Combine lines 1 and 2. Enter the result	3	$ 11, 684	00
4	Multiply line 3 by .9235. Enter the result. If the result is less than $400, **do not** file this schedule; you **do not** owe self-employment tax ▶	4	$ 10, 790	17
5	Maximum amount of combined wages and self-employment earnings subject to social security or railroad retirement (tier 1) tax for 1990	5	$51,300	00
6	Total social security wages and tips (from Form(s) W-2) and railroad retirement compensation (tier 1). **Do not** include Medicare qualified government wages on this line	6	-0-	
7	Subtract line 6 from line 5. Enter the result. If the result is zero or less, **do not** file this schedule; you **do not** owe self-employment tax ▶	7	$ 51, 300	00
8	Enter the **smaller** of line 4 or line 7	8	$ 10, 790	17
9	Rate of tax	9	×.153	
10	**Self-employment tax.** If line 8 is $51,300, enter $7,848.90. Otherwise, multiply the amount on line 8 by the decimal amount on line 9 and enter the result. Also enter this amount on Form 1040, line 48. **Note:** *Also enter one-half of this amount on Form 1040, line 25.*	10	$ 1, 651	00

For Paperwork Reduction Act Notice, see Form 1040 Instructions. Schedule SE (Form 1040) 1990



Form 4684 (1990) Attachment Sequence No. 26 Page **2**

Name(s) shown on tax return. (Do not enter name and identifying number if shown on other side.): Walter A. & Jane W. Brown
Identifying number: 579 - 00 - 6685

SECTION B.—Business and Income-Producing Property *(Casualties and thefts of property used in a trade or business or for income-producing purposes.)*

Part I Casualty or Theft Gain or Loss (Use a separate Part I for each different casualty or theft.)

1 Description of properties. (Show kind, location, and date of purchase for each.)
Property A Dairy Cow # 42, Hometown, Your State 6-21-86
Property B
Property C
Property D

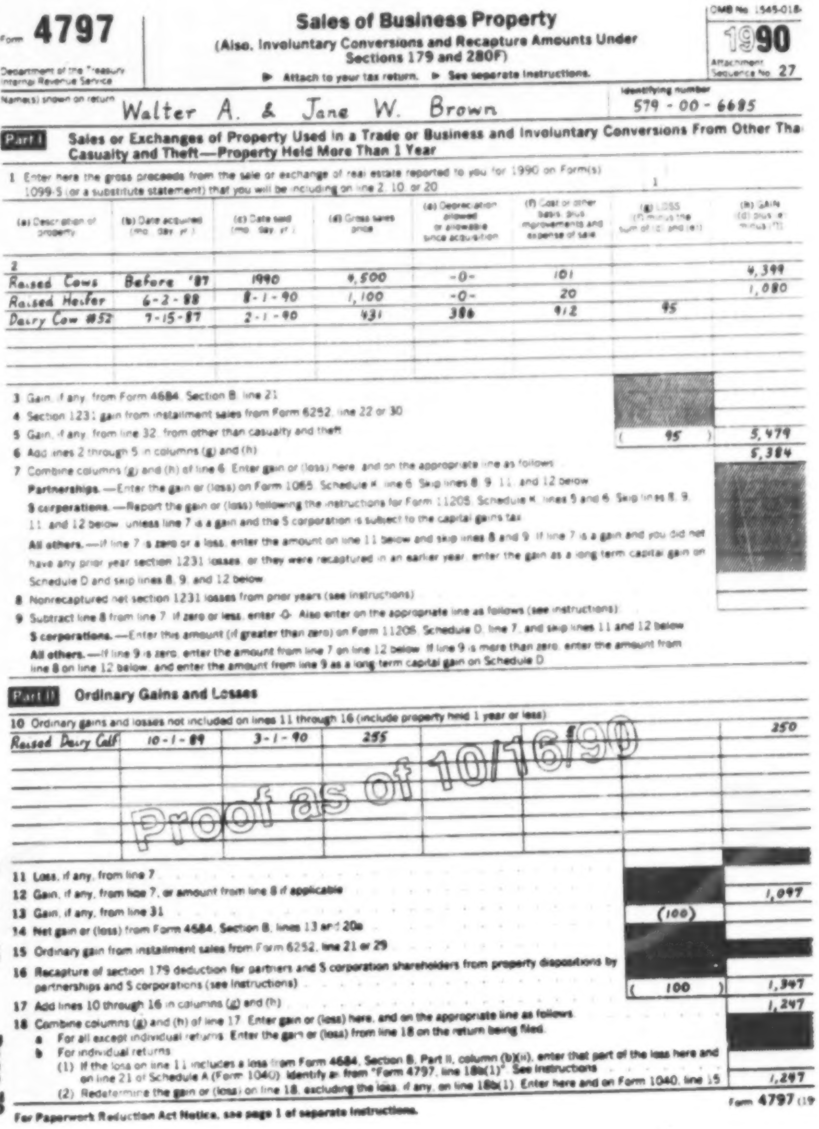
Proof as of 10/16/90

			Properties (Use a separate column for each property lost or damaged from one casualty or theft.)			
			A	B	C	D
2	Cost or adjusted basis of each property	2	252			
3	Insurance or other reimbursement (whether or not you submitted a claim). (See instructions) **Note:** *If line 2 is **more** than line 3, skip line 4.*	3	152			
4	Gain from casualty or theft. If the amount you received as reimbursement is more than your cost or other basis, enter the difference here and on line 11 or line 16, column (c). However, see instructions for line 15. Also, skip lines 5 through 9 for that column	4				
5	Fair market value **before** casualty or theft	5	500			
6	Fair market value **after** casualty or theft	6	-0-			
7	Subtract line 6 from line 5	7	500			
8	Enter the **smaller** of line 2 or line 7 **Note:** *If the property was totally destroyed by casualty, or lost from theft, enter on line 8 the amount from line 2.*	8	252			
9	Subtract line 3 from line 8 (if zero or less, enter zero)	9	100			

10	Casualty or theft loss. Add the amounts on line 9. Enter the total here and on line 11 or line 16. (See instructions)	10	100

Part II Summary of Gains and Losses (From separate Parts I)

	(a) Identify casualty or theft		(b) Losses from casualties or thefts		(c) Gains from casualties or thefts includible in income
			(i) Trade, business, rental or royalty property	(ii) Income-producing property	
	Casualty or Theft of Property Held One Year or Less				
11					
12	Totals. Add the amounts on line 11	12			
13	Combine line 12, columns (b)(i) and (c). Enter the net gain or (loss) here and on Form 4797, Part II, line 14. (If Form 4797 is not otherwise required, see Instructions.)	13			
14	Enter the amount from line 12, column (b)(ii) here and on Schedule A (Form 1040), line 21. Partnerships, S corporations, estates and trusts, see Instructions	14			
	Casualty or Theft of Property Held More Than One Year				
15	Casualty or theft gains from Form 4797, Part III, line 32	15			
16	Cow Struck By Lightning		100		
17	Total losses. Add amounts on line 16, columns (b)(i) and (b)(ii)	17	100		
18	Total gains. Add lines 15 and 16, column (c)	18			
19	Add amounts on line 17, columns (b)(i) and (b)(ii)	19			100
20	If the loss on line 19 is more than the gain on line 18:				
	a Combine line 17, column (b)(i) and line 18. Enter the net gain or (loss) here and on Form 4797, Part II, line 14. (If Form 4797 is not otherwise required, see Instructions.)	20a			(100)
	b Enter the amount from line 17, column (b)(ii) here and on Schedule A (Form 1040), line 21. Estates and trusts, enter on the "other deductions" line of your tax return	20b			
21	If the loss on line 19 is equal to or smaller than the gain on line 18, combine these lines and enter here and on Form 4797, Part I, line 3 **Note:** *Partnerships, enter the amount from line 20a, 20b, or line 21 on Form 1065, Schedule K, line 7. S corporations, enter the amount from line 20a or 20b on Form 1120S, Schedule K, line 6.*	21			



Form **4797**

Department of the Treasury
Internal Revenue Service

Sales of Business Property

(Also, Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F)

▶ Attach to your tax return. ▶ See separate instructions.

OMB No. 1545-018

1990

Attachment Sequence No. 27

Name(s) shown on return: Walter A. & Jane W. Brown

Identifying number: 579 - 00 - 6695

Part I **Sales or Exchanges of Property Used in a Trade or Business and Involuntary Conversions From Other Tha Casualty and Theft—Property Held More Than 1 Year**

1 Enter here the gross proceeds from the sale or exchange of real estate reported to you for 1990 on Form(s) 1099-S (or a substitute statement) that you will be including on line 2, 10, or 20 | 1 |

(a) Description of property	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Gross sales price	(e) Depreciation allowed or allowable since acquisition	(f) Cost or other basis, plus improvements and expense of sale	(g) LOSS ((f) minus the sum of (d) and (e))	(h) GAIN ((d) plus (e) minus (f))
2							
Raised Cows	Before '87	1990	4,500	-0-	101		4,399
Raised Heifer	6-2-88	8-1-90	1,100	-0-	20		1,080
Dairy Cow #52	7-15-87	2-1-90	431	386	912	95	

3 Gain, if any, from Form 4684, Section B, line 21		
4 Section 1231 gain from installment sales from Form 6252, line 22 or 30		
5 Gain, if any, from line 32, from other than casualty and theft	(95)	5,479
6 Add lines 2 through 5 in columns (g) and (h)		5,384
7 Combine columns (g) and (h) of line 6. Enter gain or (loss) here, and on the appropriate line as follows:		

Partnerships.—Enter the gain or (loss) on Form 1065, Schedule K, line 6. Skip lines 8, 9, 11, and 12 below.

S corporations.—Report the gain or (loss) following the instructions for Form 1120S, Schedule K, lines 5 and 6. Skip lines 8, 9, 11, and 12 below, unless line 7 is a gain and the S corporation is subject to the capital gains tax.

All others.—If line 7 is zero or a loss, enter the amount on line 11 below and skip lines 8 and 9. If line 7 is a gain and you did not have any prior year section 1231 losses, or they were recaptured in an earlier year, enter the gain as a long-term capital gain on Schedule D and skip lines 8, 9, and 12 below.

8 Nonrecaptured net section 1231 losses from prior years (see instructions)

9 Subtract line 8 from line 7. If zero or less, enter -0-. Also enter on the appropriate line as follows (see instructions):

S corporations.—Enter this amount (if greater than zero) on Form 1120S, Schedule D, line 7, and skip lines 11 and 12 below.

All others.—If line 9 is zero, enter the amount from line 7 on line 12 below. If line 9 is more than zero, enter the amount from line 8 on line 12 below, and enter the amount from line 9 as a long-term capital gain on Schedule D.

Part II **Ordinary Gains and Losses**

10 Ordinary gains and losses not included on lines 11 through 16 (include property held 1 year or less):

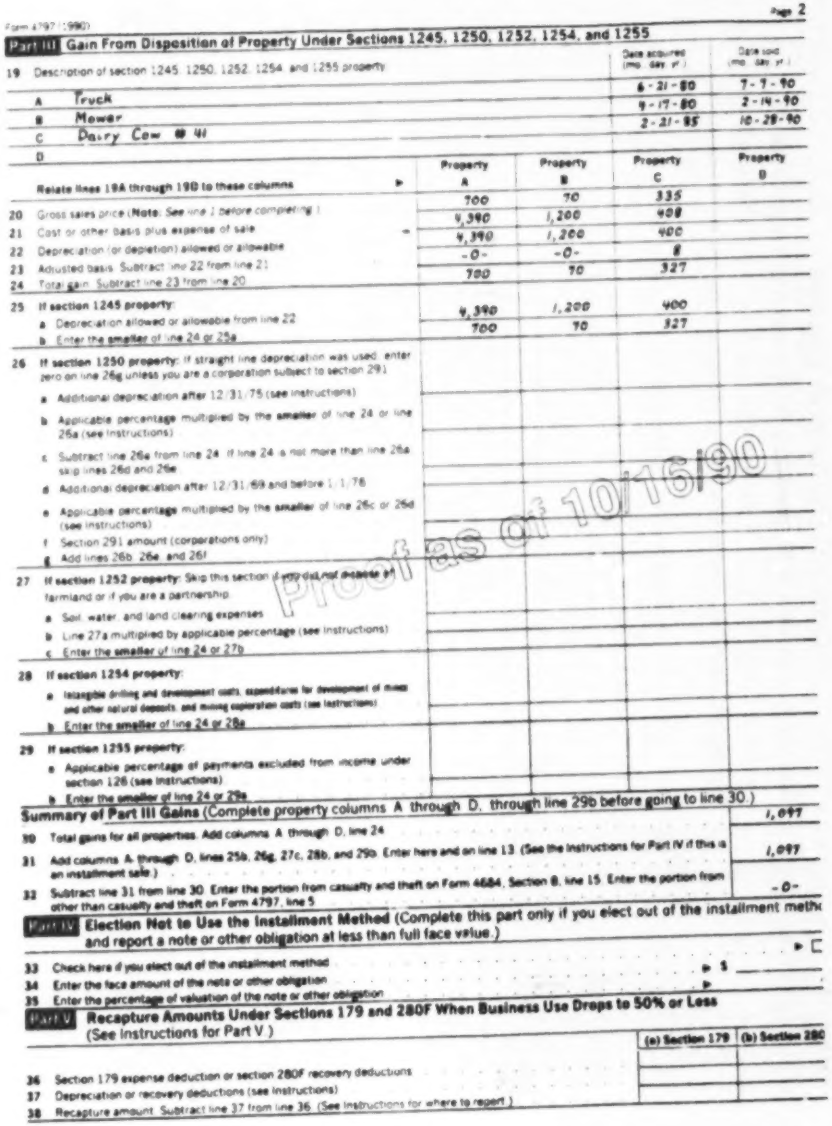
Raised Dairy Calf	10-1-89	3-1-90	255				250

Proof as of 10/16/90

	(g)	(h)
11 Loss, if any, from line 7		
12 Gain, if any, from line 7, or amount from line 8 if applicable		1,097
13 Gain, if any, from line 31	(100)	
14 Net gain or (loss) from Form 4684, Section B, lines 13 and 20a		
15 Ordinary gain from installment sales from Form 6252, line 21 or 29		
16 Recapture of section 179 deduction for partners and S corporation shareholders from property dispositions by partnerships and S corporations (see instructions)	(100)	1,347
17 Add lines 10 through 16 in columns (g) and (h)		1,247

18 Combine columns (g) and (h) of line 17. Enter gain or (loss) here, and on the appropriate line as follows:
- a For all except individual returns: Enter the gain or (loss) from line 18 on the return being filed.
- b For individual returns:
  - (1) If the loss on line 11 includes a loss from Form 4684, Section B, Part II, column (b)(ii), enter that part of the loss here and on line 21 of Schedule A (Form 1040). Identify as from "Form 4797, line 18b(1)". See instructions
  - (2) Redetermine the gain or (loss) on line 18, excluding the loss, if any, on line 18b(1). Enter here and on Form 1040, line 15 — 1,247

For Paperwork Reduction Act Notice, see page 1 of separate instructions. Form **4797** (19



Form 4797 (1990) Page **2**

Part III **Gain From Disposition of Property Under Sections 1245, 1250, 1252, 1254, and 1255**

19 Description of section 1245, 1250, 1252, 1254, and 1255 property	Date acquired (mo., day, yr.)	Date sold (mo., day, yr.)
A Truck	6-21-80	7-7-90
B Mower	9-17-80	2-14-90
C Dairy Cow # 41	2-21-85	10-29-90
D		

Relate lines 19A through 19D to these columns ▶	Property A	Property B	Property C	Property D
20 Gross sales price (**Note:** *See line 1 before completing.*)	700	70	335	
21 Cost or other basis plus expense of sale	4,390	1,200	408	
22 Depreciation (or depletion) allowed or allowable	4,390	1,200	400	
23 Adjusted basis. Subtract line 22 from line 21	-0-	-0-	8	
24 Total gain. Subtract line 23 from line 20	700	70	327	
25 **If section 1245 property:**				
a Depreciation allowed or allowable from line 22	4,390	1,200	400	
b Enter the **smaller** of line 24 or 25a	700	70	327	
26 **If section 1250 property:** If straight line depreciation was used, enter zero on line 26g unless you are a corporation subject to section 291				
a Additional depreciation after 12/31/75 (see instructions)				
b Applicable percentage multiplied by the **smaller** of line 24 or line 26a (see instructions)				
c Subtract line 26a from line 24. If line 24 is not more than line 26a, skip lines 26d and 26e				
d Additional depreciation after 12/31/69 and before 1/1/76				
e Applicable percentage multiplied by the **smaller** of line 26c or 26d (see instructions)				
f Section 291 amount (corporations only)				
g Add lines 26b, 26e, and 26f				
27 **If section 1252 property:** Skip this section if you did not dispose of farmland or if you are a partnership				
a Soil, water, and land clearing expenses				
b Line 27a multiplied by applicable percentage (see instructions)				
c Enter the **smaller** of line 24 or 27b				
28 **If section 1254 property:**				
a Intangible drilling and development costs, expenditures for development of mines and other natural deposits, and mining exploration costs (see instructions)				
b Enter the **smaller** of line 24 or 28a				
29 **If section 1255 property:**				
a Applicable percentage of payments excluded from income under section 126 (see instructions)				
b Enter the **smaller** of line 24 or 29a				

Proof as of 10/16/90

Summary of Part III Gains (Complete property columns A through D, through line 29b before going to line 30.)

30 Total gains for all properties. Add columns A through D, line 24	1,097
31 Add columns A through D, lines 25b, 26g, 27c, 28b, and 29b. Enter here and on line 13. (See the instructions for Part IV if this is an installment sale.)	1,097
32 Subtract line 31 from line 30. Enter the portion from casualty and theft on Form 4684, Section B, line 15. Enter the portion from other than casualty and theft on Form 4797, line 5	-0-

Part IV **Election Not to Use the Installment Method** (Complete this part only if you elect out of the installment metho and report a note or other obligation at less than full face value.)

33 Check here if you elect out of the installment method ▶ ☐

34 Enter the face amount of the note or other obligation ▶ $ ____

35 Enter the percentage of valuation of the note or other obligation ▶

Part V **Recapture Amounts Under Sections 179 and 280F When Business Use Drops to 50% or Less** (See Instructions for Part V.)

	(a) Section 179	(b) Section 280
36 Section 179 expense deduction or section 280F recovery deductions		
37 Depreciation or recovery deductions (see instructions)		
38 Recapture amount. Subtract line 37 from line 36. (See instructions for where to report.)		

SCHEDULE D
(Form 1040)

Department of the Treasury
Internal Revenue Service

Capital Gains and Losses

(And Reconciliation of Forms 1099-B for Bartering Transactions)

► Attach to Form 1040. ► See Instructions for Schedule D (Form 1040).
► For more space to list transactions for lines 2a and 9a, get Schedule D-1 (Form 1040).

OMB No. 1545-0074
1990
Attachment Sequence No. 12A

Name(s) shown on Form 1040: Walter A. & Jane W. Brown
Your social security number: 579 00 6685

1 Enter the total sales of stocks, bonds, other securities, and real estate transactions reported to you for 1990 on Forms 1099-B and 1099-S (or on substitute statements). If this total is not the same as the total of lines 2c and 9c, column (d), attach a statement explaining the difference. (Do not include on this line amounts from Form 1099-S if you reported them on another form or schedule.) **See Instructions for line 1**	1	1,400

Part I Short-Term Capital Gains and Losses—Assets Held One Year or Less

(a) Description of property (Example, 100 shares 7% preferred of "Z" Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see Instructions)	(e) Cost or other basis (see Instructions)	(f) LOSS If (e) is more than (d), subtract (d) from (e)	(g) GAIN If (d) is more than (e), subtract (e) from (d)
2a Stocks, Bonds, Other Securities, and Real Estate. Include Form 1099-B and 1099-S Transactions. See Instructions.						
25 shares H. T. Corp.	12-1-90	3-3-90	400	450	50	
2b Amounts from Schedule D-1, line 2b (attach Schedule D-1)						
2c Total of All Sales Price Amounts. Add column (d) of lines 2a and 2b ► 2c			400			
2d Other Transactions (Do NOT include real estate transactions from Forms 1099-S. Report them on line 2a.)						
Bad Debt	10-8-83	Worthless			50	

3 Short-term gain from sale or exchange of your home from Form 2119, line 10 or 14c	3		
4 Short-term gain from installment sales from Form 6252, line 22 or 30	4		
5 Net short-term gain or (loss) from partnerships, S corporations, and fiduciaries	5		
6 Short-term capital loss carryover from 1989 Schedule D, line 29	6		
7 Add lines 2a, 2b, 2d, and 3 through 6, in columns (f) and (g)	7	(100)	
8 **Net short-term gain or (loss).** Combine columns (f) and (g) of line 7	8		(100)

Part II Long-Term Capital Gains and Losses—Assets Held More Than One Year

(a) Description of property	(b) Date acquired	(c) Date sold	(d) Sales price	(e) Cost or other basis	(f) LOSS	(g) GAIN
9a Stocks, Bonds, Other Securities, and Real Estate. Include Form 1099-B and 1099-S Transactions. See Instructions.						
40 shares H. T. Corp.	1976	6-5-90	1,000	255		745
9b Amounts from Schedule D-1, line 9b (attach Schedule D-1)						
9c Total of All Sales Price Amounts. Add column (d) of lines 9a and 9b ► 9c			1,000			
9d Other Transactions (Do NOT include real estate transactions from Forms 1099-S. Report them on line 9a.)						

Proof as of 10/16/90

10 Long-term gain from sale or exchange of your home from Form 2119, line 10 or 14c	10		
11 Long-term gain from installment sales from Form 6252, line 22 or 30	11		
12 Net long-term gain or (loss) from partnerships, S corporations, and fiduciaries	12		
13 Capital gain distributions	13		
14 Gain from Form 4797, line 7 or 9	14		5,384
15 Long-term capital loss carryover from 1989 Schedule D, line 36	15		
16 Add lines 9a, 9b, 9d, and 10 through 15, in columns (f) and (g)	16	( )	6,129
17 **Net long-term gain or (loss).** Combine columns (f) and (g) of line 16	17		6,129

For Paperwork Reduction Act Notice, see Form 1040 Instructions.

Schedule D (Form 1040) 1990

Schedule D (Form 1040) 1990 Attachment Sequence No. 12A Page 2

Name(s) shown on Form 1040. (Do not enter name and social security number if shown on other side.)
Walter A. & Jane W. Brown

Your social security number
579 00 6685

Part III Summary of Parts I and II

18	Combine lines 8 and 17, and enter the net gain or (loss) here. If the result is a gain, **stop here** and also enter the gain on Form 1040, line 13	18	6,029
19	If line 18 is a (loss), enter here and as a (loss) on Form 1040, line 13, the **smaller** of:		
a	The (loss) on line 18; **or**		
b	($3,000) or, if married filing a separate return, ($1,500)	19	( )

Note: *When figuring whether line 19a or 19b is* **smaller**, *treat both numbers as if they were positive.*

Go on to Part IV if the loss on line 18 is more than $3,000 ($1,500, if married filing a separate return), OR if taxable income on Form 1040, line 37, is zero.

Part IV Capital Loss Carryovers from 1990 to 1991

Section A.—Carryover Limit

20	Enter taxable income from Form 1040, line 37. **(If Form 1040, line 37 is zero, see instructions for amount to enter.)**	20	

Note: *For lines 21 through 36, enter all amounts as positive numbers.*

21	Enter the loss on line 19	21	
22	Enter the amount on Form 1040, line 36	22	
23	Combine lines 20, 21, and 22. If zero or less, enter -0-	23	
24	**Carryover Limit.** Enter the **smaller** of line 21 or line 23	24	

Section B.—Short-Term Capital Loss Carryover to 1991

(Complete this section only if there is a loss on both line 8 and line 19. Otherwise, go on to Section C.)

25	Enter the loss on line 8			25	
26	Enter the gain, if any, on line 17	26			
27	Enter the amount on line 24	27			
28	Add lines 26 and 27			28	
29	**Short-term capital loss carryover to 1991.** Subtract line 28 from line 25. If zero or less, enter -0-			29	

Section C.—Long-Term Capital Loss Carryover to 1991

(Complete this section only if there is a loss on both line 17 and line 19.)

30	Enter the loss on line 17			30	
31	Enter the gain, if any, on line 8			31	
32	Enter the amount on line 24	32			
33	Enter the amount, if any, on line 25.	33			
34	Subtract line 33 from line 32. If zero or less, enter -0-			34	
35	Add lines 31 and 34.			35	
36	**Long-term capital loss carryover to 1991.** Subtract line 35 from line 30. If zero or less, enter -0-			36	

Part V Election Not to Use the Installment Method (Complete this part only if you elect out of the installment method and report a note or other obligation at less than full face value.)

37 Check here if you elect out of the installment method ▶ ☐

38 Enter the face amount of the note or other obligation ▶

39 Enter the percentage of valuation of the note or other obligation ▶

Part VI Reconciliation of Forms 1099-B for Bartering Transactions

(Complete this part if you received one or more Forms 1099-B or substitute statements reporting bartering income.)

			Amount of bartering income from Form 1099-B or substitute statement reported on form or schedule
40	Form 1040, line 22	40	
41	Schedule C (Form 1040)	41	
42	Schedule D (Form 1040)	42	
43	Schedule E (Form 1040)	43	
44	Schedule F (Form 1040)	44	
45	Other form or schedule (identify) (if nontaxable, indicate reason—attach additional sheets if necessary):	45	
46	Total (add lines 40 through 45)	46	

Note: *The amount on line 46 should be the same as the total bartering income on all Forms 1099-B and substitute statements received for bartering transactions.*

Proof as of 10/16/90

Form **1040** Department of the Treasury—Internal Revenue Service

U.S. Individual Income Tax Return 1990

For the year Jan.–Dec. 31, 1990, or other tax year beginning , 1990, ending 19 | OMB No. 1545-0074

Label (See Instructions on page 8.)
Use IRS label. Otherwise, please print or type.

LABEL HERE

Your first name and initial | Last name

VY 579-00-6685 579-00-8921 DO 04 3
WALTER A & JANE W BROWN
RR 1 Box 25
HOMETOWN YOUR STATE 02115

City, town or post office, state, and ZIP code. (If you have a foreign address, see page 9.)

IRS

Apt. no.

Your social security number

Spouse's social security number

For Privacy Act and Paperwork Reduction Act Notice, see Instructions.

Presidential Election Campaign (See page 9.)

Do you want $1 to go to this fund?	✓ Yes	No	**Note:** *Checking "Yes" will not change your tax or reduce your refund.*
If joint return, does your spouse want $1 to go to this fund?	✓ Yes	No	

Filing Status

Check only one box.

1 ☐ Single. (See page 10 to find out if you can file as head of household.)
2 ☑ Married filing joint return (even if only one had income)
3 ☐ Married filing separate return. Enter spouse's social security no. above and full name here. ▶
4 ☐ Head of household (with qualifying person). (See page 10.) If the qualifying person is your child but not your dependent, enter this child's name here. ▶
5 ☐ Qualifying widow(er) with dependent child (year spouse died ▶ 19). (See page 10.)

Exemptions

(See Instructions on page 10.)

6a ☑ **Yourself** If your parent (or someone else) can claim you as a dependent on his or her tax return, do not check box 6a. But be sure to check the box on line 33b on page 2 .

b ☑ **Spouse**

No. of boxes checked on 6a and 5b 2

c **Dependents:**

(1) Name (first, initial, and last name)	(2) Check if under age 2	(3) If age 2 or older, dependent's social security number	(4) Dependent's relationship to you	(5) No. of months lived in your home in 1990
Linda		580 : 00 : 8877	Daughter	12
Greg		589 : 00 : 4400	Son	12
Sara	✓		Daughter	12

If more than 6 dependents, see Instructions on page 11.

No. of your children on 6c who:
- lived with you 3
- didn't live with you due to divorce or separation (see page 11)

No. of other dependents on 6c

d If your child didn't live with you but is claimed as your dependent under a pre-1985 agreement, check here ▶ ☐

e Total number of exemptions claimed

Add numbers entered on lines above ▶ 5

Income

Attach Copy B of your Forms W-2, W-2G, and W-2P here.

If you do not have a W-2, see page 8.

Attach check or money order on top of any Forms W-2, W-2G, or W-2P.

7	Wages, salaries, tips, etc. *(attach Form(s) W-2)*	7	3,095
8a	**Taxable** interest income *(also attach Schedule B if over $400)*	8a	375
b	**Tax-exempt** interest income (see page 13). DON'T include on line 8a 8b		
9	Dividend income *(also attach Schedule B if over $400)*	9	220
10	Taxable refunds of state and local income taxes, if any, from worksheet on page 14	10	
11	Alimony received	11	
12	Business income or (loss) *(attach Schedule C)*	12	
13	Capital gain or (loss) *(attach Schedule D)*	13	6,029
14	Capital gain distributions not reported on line 13 (see page 14)	14	
15	Other gains or (losses) *(attach Form 4797)*	15	1,247
16a	Total IRA distributions 16a — 16b Taxable amount (see page 14)	16b	
17a	Total pensions and annuities 17a — 17b Taxable amount (see page 14)	17b	
18	Rents, royalties, partnerships, estates, trusts, etc. *(attach Schedule E)*	18	
19	Farm income or (loss) *(attach Schedule F)*	19	11,684
20	Unemployment compensation (insurance) (see page 16)	20	
21a	Social security benefits 21a — 21b Taxable amount (see page 16)	21b	
22	Other income (list type and amount—see page 16)	22	
23	Add the amounts shown in the far right column for lines 7 through 22. This is your **total income** ▶	23	22,650

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Adjustments to Income

(See Instructions on page 17.)

24a	Your IRA deduction, from applicable worksheet on page 17 or 18	24a	
b	Spouse's IRA deduction, from applicable worksheet on page 17 or 18	24b	
25	One-half of self-employment tax (see page 18)	25	
26	Self-employed health insurance deduction, from worksheet on page 18	26	
27	Keogh retirement plan and self-employed SEP deduction	27	
28	Penalty on early withdrawal of savings	28	
29	Alimony paid. Recipient's SSN ▶	29	
30	Add lines 24a through 29. These are your **total adjustments** ▶	30	

Adjusted Gross Income

31 Subtract line 30 from line 23. This is your **adjusted gross income.** *If this amount is less than $20,264 and a child lived with you, see page 23 to find out if you can claim the "Earned Income Credit" on line 57* ▶ 31 22,650

Proof as of 10/16/90

Tax Computation

If you want IRS to figure your tax, see Instructions on page 19.

No.	Item	Line	Amount	Line	Amount
32	Amount from line 31 (adjusted gross income)			32	22,650
33a	Check if: ☐ You were 65 or older ☐ Blind; ☐ Spouse was 65 or older ☐ Blind. Add the number of boxes checked above and enter the total here ▶ 33a				
b	If your parent (or someone else) can claim you as a dependent, check here ▶ 33b ☐				
c	If you are married filing a separate return and your spouse itemizes deductions, or you are a dual-status alien, see page 19 and check here ▶ 33c ☐				
34	Enter the larger of: • Your **standard deduction** (from the chart (or worksheet) on page 20 that applies to you), **OR** • Your **itemized deductions** (from Schedule A, line 27). If you itemize, attach Schedule A and check here. ▶ ☑			34	5,764
35	Subtract line 34 from line 32			35	16,886
36	Multiply $2,050 by the total number of exemptions claimed on line 6e			36	10,250
37	**Taxable income.** Subtract line 36 from line 35. (If line 36 is more than line 35, enter -0-.)			37	6,636
38	Enter tax. Check if from: a ☑ Tax Table, b ☐ Tax Rate Schedules, or c ☐ Form 8615 (see page 21) (If any is from Form(s) 8814, enter that amount here ▶ d ______ .)			38	994
39	Additional taxes (see page 21). Check if from: a ☐ Form 4970 b ☐ Form 4972			39	
40	Add lines 38 and 39 ▶			40	994

Credits

(See Instructions on page 21.)

No.	Item	Line	Amount	Line	Amount
41	Credit for child and dependent care expenses *(attach Form 2441)*	41			
42	Credit for the elderly or the disabled *(attach Schedule R)*	42			
43	Foreign tax credit *(attach Form 1116)*	43			
44	General business credit. Check if from: a ☐ Form 3800 or b ☐ Form (specify) ______	44			
45	Credit for prior year minimum tax *(attach Form 8801)*	45			
46	Add lines 41 through 45			46	-0-
47	Subtract line 46 from line 40. (If line 46 is more than line 40, enter -0-.) ▶			47	994

Other Taxes

No.	Item	Line	Amount	Line	Amount
48	Self-employment tax *(attach Schedule SE)*			48	1,651
49	Alternative minimum tax *(attach Form 6251)*			49	
50	Recapture taxes (see page 22). Check if from: a ☐ Form 4255 b ☐ Form 8611			50	
51	Social security tax on tip income not reported to employer *(attach Form 4137)*			51	
52	Tax on an IRA or a qualified retirement plan *(attach Form 5329)*			52	
53	Advance earned income credit payments from Form W-2			53	
54	Add lines 47 through 53. This is your **total tax** ▶			54	2,645

Payments

Attach Forms W-2, W-2G, and W-2P to front.

No.	Item	Line	Amount	Line	Amount
55	Federal income tax withheld **(If any is from Form(s) 1099, check ▶ ☐)**	55	227		
56	1990 estimated tax payments and amount applied from 1989 return	56			
57	**Earned income credit** (see page 23)	57			
58	Amount paid with Form 4868 (extension request)	58			
59	Excess social security tax and RRTA tax withheld (see page 24)	59			
60	Credit for Federal tax on fuels *(attach Form 4136)*	60	350		
61	Regulated investment company credit *(attach Form 2439)*	61			
62	Add lines 55 through 61. These are your **total payments** ▶			62	577

Refund or Amount You Owe

No.	Item	Line	Amount	Line	Amount
63	If line 62 is more than line 54, enter amount **OVERPAID** ▶			63	
64	Amount of line 63 to be **REFUNDED TO YOU** ▶			64	
65	Amount of line 63 to be **APPLIED TO YOUR 1991 ESTIMATED TAX** ▶	65			
66	If line 54 is more than line 62, enter **AMOUNT YOU OWE.** Attach check or money order for full amount payable to "Internal Revenue Service." Write your name, address, social security number, daytime phone number, and "1990 Form 1040" on it.			66	2,068
67	Estimated tax penalty (see page 25)	67			

Sign Here

Keep a copy of this return for your records.

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Your signature: Walter A. Brown — Date: 2-22-91 — Your occupation: Farmer

Spouse's signature (if joint return, BOTH must sign): Jane H. Brown — Date: 2-22-91 — Spouse's occupation: Homemaker

Paid Preparer's Use Only

Preparer's signature ▶ — Date — Check if self-employed ☐ — Preparer's social security no.

Firm's name (or yours if self-employed) and address ▶ — E.I. No. — ZIP code

SCHEDULES A&B
(Form 1040)
Department of the Treasury
Internal Revenue Service

Schedule A—Itemized Deductions

(Schedule B is on back)

▶ Attach to Form 1040. ▶ See Instructions for Schedules A and B (Form 1040).

OMB No. 1545-0074
1990
Attachment Sequence No. **07**

Name(s) shown on Form 1040: Walter A. & Jane W. Brown

Your social security number: 579 00 6685

Medical and Dental Expenses		**Caution:** *Do not include expenses reimbursed or paid by others.*				
	1	Medical and dental expenses. (See page 27 of the Instructions.)	1	1,946		
	2	Enter amount from Form 1040, line 32 . . . [2] 22,650				
	3	Multiply the amount on line 2 by 7.5% (.075). Enter the result	3	1,699		
	4	Subtract line 3 from line 1. Enter the result. If less than zero, enter -0- ▶			4	247
Taxes You Paid (See Instructions on page 27.)	5	State and local income taxes	5	1,780		
	6	Real estate taxes	6	962		
	7	Other taxes. (List—include personal property taxes.) ▶	7			
	8	Add the amounts on lines 5 through 7. Enter the total ▶			8	2,742
Interest You Paid (See Instructions on page 27.)	9a	Deductible home mortgage interest paid to financial institutions and reported to you on Form 1098. Report deductible points on line 10.	9a	2,200		
	b	Other deductible home mortgage interest. (If paid to an individual, show that person's name and address.) ▶	9b			
	10	Deductible points. (See Instructions for special rules.)	10			
	11	Deductible investment interest (attach Form 4952 if required). (See page 28.)	11			
	12a	Personal interest you paid. (See page 28.) [12a]				
	b	Multiply the amount on line 12a by 10% (.10). Enter the result	12b			
	13	Add the amounts on lines 9a through 11, and 12b. Enter the total ▶			13	2,200
Gifts to Charity (See Instructions on page 29.)		**Caution:** *If you made a charitable contribution and received a benefit in return, see page 29 of the Instructions.*				
	14	Contributions by cash or check	14	575		
	15	Other than cash or check. (You **MUST** attach Form 8283 if over $500.)	15			
	16	Carryover from prior year	16			
	17	Add the amounts on lines 14 through 16. Enter the total ▶			17	575
Casualty and Theft Losses	18	Casualty or theft loss(es) (attach Form 4684). (See page 29 of the Instructions.) ▶			18	
Moving Expenses	19	Moving expenses (attach Form 3903 or 3903F). (See page 30 of the Instructions.) ▶			19	
Job Expenses and Most Other Miscellaneous Deductions (See Instructions on page 30 for expenses to deduct here.)	20	Unreimbursed employee expenses—job travel, union dues, job education, etc. (You **MUST** attach Form 2106 if required. See Instructions.) ▶	20			
	21	Other expenses (investment, tax preparation, safe deposit box, etc.). List type and amount ▶ Safe Deposit Box	21	42		
	22	Add the amounts on lines 20 and 21. Enter the total	22	42		
	23	Enter amount from Form 1040, line 32 . [23] 22,650				
	24	Multiply the amount on line 23 by 2% (.02). Enter the result	24	453		
	25	Subtract line 24 from line 22. Enter the result. If less than zero, enter -0- ▶			25	-0-
Other Miscellaneous Deductions	26	Other (from list on page 30 of Instructions). List type and amount ▶			26	
Total Itemized Deductions	27	Add the amounts on lines 4, 8, 13, 17, 18, 19, 25, and 26. Enter the total here. Then enter on Form 1040, line 34, the **LARGER** of this total or your standard deduction from page 20 of the Instructions ▶			27	5,764

Proof as of 10/16/90

For Paperwork Reduction Act Notice, see Form 1040 Instructions.

Schedule A (Form 1040) 1990

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S Publications

ed below are the numbers and titles of cted IRS tax publications. The list includes all publications referred to in the chapters of this k, as well as others that might be of interest to . A full list can be found in Publication 910, *ide to Free Tax Services*. If you only need to *er tax forms and publications* and do not e any tax questions, call 1-800-TAX-FORM 800-829-3676).

eral Guides
1 ..... Your Rights as a Taxpayer
17 ..... Your Federal Income Tax (an income tax guide for individuals)
334 ..... Tax Guide for Small Business
509 ..... Tax Calendars for 1991
553 ..... Highlights of 1990 Tax Changes
595 ..... Tax Guide for Commercial Fishermen
910 ..... Guide to Free Tax Services
51 ..... Circular A, Agricultural Employer's Tax Guide
15 ..... Circular E, Employer's Tax Guide

ecialized Publications:
349 ..... Federal Highway Use Tax on Heavy Vehicles
378 ..... Fuel Tax Credits and Refunds
448 ..... Federal Estate and Gift Taxes
463 ..... Travel, Entertainment, and Gift Expenses
501 ..... Exemptions, Standard Deduction, and Filing Information
502 ..... Medical and Dental Expenses
503 ..... Child and Dependent Care Expenses
504 ..... Tax Information for Divorced or Separated Individuals
505 ..... Tax Withholding and Estimated Tax
510 ..... Excise Taxes for 1991
514 ..... Foreign Tax Credit for Individuals
521 ..... Moving Expenses
523 ..... Tax Information on Selling Your Home
524 ..... Credit for the Elderly or the Disabled
525 ..... Taxable and Nontaxable Income
526 ..... Charitable Contributions
527 ..... Residential Rental Property
529 ..... Miscellaneous Deductions
533 ..... Self-Employment Tax
534 ..... Depreciation
535 ..... Business Expenses
536 ..... Net Operating Losses
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542 ..... Tax Information on Corporations
544 ..... Sales and Other Dispositions of Assets
545 ..... Interest Expense
547 ..... Nonbusiness Disasters, Casualties, and Thefts
550 ..... Investment Income and Expenses
551 ..... Basis of Assets
554 ..... Tax Information for Older Americans
556 ..... Examination of Returns, Appeal Rights, and Claims for Refund
559 ..... Tax Information for Survivors, Executors, and Administrators
560 ..... Retirement Plans for the Self-Employed
561 ..... Determining the Value of Donated Property
583 ..... Taxpayers Starting a Business
584 ..... Nonbusiness Disaster, Casualty, and Theft Loss Workbook
586A ..... The Collection Process (Income Tax Accounts)
587 ..... Business Use of Your Home
589 ..... Tax Information on S Corporations
590 ..... Individual Retirement Arrangements (IRAs)
594 ..... The Collection Process (Employment Tax Accounts)
909 ..... Alternative Minimum Tax for Individuals
911 ..... Tax Information for Direct Sellers
915 ..... Social Security Benefits and Equivalent Railroad Retirement Benefits
917 ..... Business Use of a Car
925 ..... Passive Activity and At-Risk Rules
926 ..... Employment Taxes for Household Employers
929 ..... Tax Rules for Children and Dependents
937 ..... Business Reporting (Employment Taxes and Information Returns)
1544 ..... Reporting Cash Payments of Over $10,000

Spanish Language Publications:
179 ..... Circular PR, Guía Contributiva Federal Para Patronos Puertorriqueños
556S ..... Revisión de las Declaraciones de Impuesto, Derecho de Apelación y Reclamaciones de Reembolso
579S ..... Cómo Preparar la Declaración de Impuesto Federal
586S ..... Proceso de Cobro (Deudas del impuesto sobre ingreso)
850 ..... English-Spanish Glossary of Words and Phrases Used in Publications Issued by the Internal Revenue Service

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